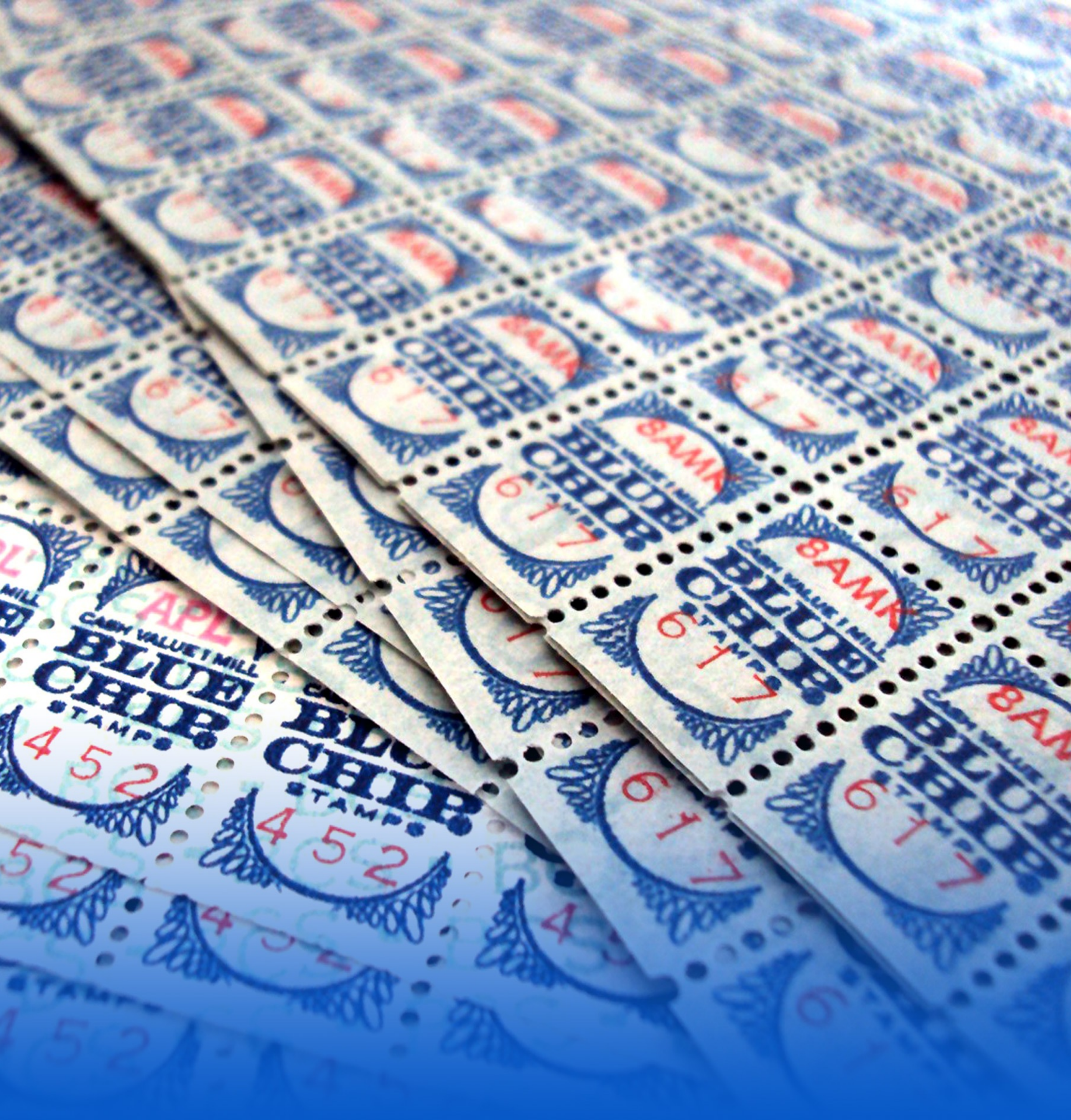

BLUE CHIP

STAMPS

1978-1982

Blue Chip Stamps

A case study of Warren Buffett and Charlie Munger's investment in and management of Blue Chip Stamps. Includes:

- Letters 1978-1982 (final letter before merger with Berkshire)
- Financials (https://docs.google.com/spreadsheets/d/1M_pui2-0EDdvo4ndIVbBJ-UrwpCQ9gpuo1dkP2WWWYo/edit?usp=sharing)

If you find any errors or have any other contributions, make a pull request or contact me through the Twitter handle @maxolson.

Contributors

- Max Olson (@maxolson)

To Our Stockholders

Consolidated normal operating income (i.e., before parent company gains from sale of securities) for the calendar year 1978 increased slightly, to $13,553,000 ($2.62 per share) from $12,893,000 ($2.49 per share) in the previous fiscal year.

Consolidated net income (i.e. , after parent company gains from sale of securities) decreased to $14,280,000 ($2.76 per share) from $16,993,000 ($3.28 per share) in the previous fiscal year.

Our constituent businesses produce fluctuating returns from normal operations as well as from gains or losses on sale of securities held to offset liabilities to trading stamp savers and others. Given this situation, our objective is to earn from all sources a fluctuating return on our shareholders' equity which amounts to a respectable average annual return over a period of years. Last year's total consolidated net income of $14,280,000 represented a return of 14.4% of our shareholders' equity of $99,251,000 at the start of the year. Over the last five years return on shareholders' equity has averaged 15%.

We have three major subsidiaries, See's Candy Shops, Incorporated (100% owned), Wesco Financial Corporation (80% owned) and Buffalo Evening News, Inc. (100% owned). If we used "equity accounting" instead of "consolidated accounting" for See's and the Buffalo Evening News as well as Wesco, our consolidated income for our two reporting years just ended would break down as follows:

Year ended about	Blue Chip equity in See's net income*1	Blue Chip equity in Wesco net income*2	Blue Chip equity in Buffalo Evening News net income (loss)*3	All other Blue Chip net income*4,5	Blue Chip consolidated net income*5
December 31, 1978	$5,802,000	$7,417,000	$(1,427,000)	$2,488,000	$14,280,000
Per Blue Chip share	1.12	1.43	(.27)	.48	2.76
December 31, 1977	5,750,000	5,715,000	340,000	5,188,000	16,993,000
Per Blue Chip share	1.11	1.10	.07	1.00	3.28

- 1 Afterreducing income by amortization· of intangibles arising from purchase of See's at a largepremium over its book value.
- 2 After increasing income by amortization of the discount from Wesco book value at which the interest was acquired.
- 3 After reducing income by amortization of relatively minOr intangibles arising at acquisition of the newspaper in April 1977;
- 4 After deduction of interest and other general corporate expenses. In each year there was an operating loss before securities transactions and before.crediting income for (i) interest and dividends resulting from investment of the funds available through "float" caused by trading stamps issued but not yet redeemed, plus (ii) income tax benefit caused by 85% exclusion of dividends in computing federal income taxes.
- 5 The 1978 amounts include $727,000 or $.14 per Blue Chip share from securities gains, net of taxes. In 1977 such securities gains were $4,100,000 or $.79 per Blue Chip share.

SEE'S CANDY SHOPS, INCORPORATED

By a razor-thin margin, our 100%-owned subsidiary, See's Candy Shops, Incorporated, had another record year under the skilled leadership of Charles Huggins. The nominal percentage gain in earnings (less than 1%) was much lower than the percentage gain in sales (17%). Comparative figures for See's for the last two years are set forth below:

Year ended about	Sales	Profits after taxes*	Number of pounds of candy sold	Number of stores open at yearend
December 31,				

1978	$73,653,000	$6,289,000	22,407,000	182
December 31, 1977	62,888,000	6,262,000	20,921,000	179

- These earnings figures are a little higher than Blue Chip Stamps' share of See's earnings shown in the table above because Blue Chip's share reflects (i) deduction of the approximately 1% share of See's earnings owned by minority stockholders of See's prior to June 6, 1978. (ii) amortization of intangibles arising from purchase of See's stock at a large premiumoverqook value, and (iii) state income taxes on See's dividends received by Blue Chip.

Boxed chocolate consumption' per capita in the United States continues to be essentially static, and the candy-store business has been subject to extraordinary cost pressure. Despite substantial increases in See's retail prices, its profits lagged substantially below year-earlier levels until December when an extraordinary burst of holiday-period sales caused the lag to be eliminated. It is very difficult to cope so successfully with the production and distribution problems ofa seasonal sales peak which becomes more extreme each year, and the flat earnings trend of 1978 represented outstanding managerial achievement. So far as we know the candy-store business is terrible to mediocre for all other companies, whereas it is quite profitable at See's for the simple reason that both new and old customers have a pronounced tendency to prefer its candy to all others. This customer enthusiasmis caused by a virtually fanatic insistence on expensive natural candy ingredients plus expensive manufacturing and distributing methods ensuring rigorous quality control and cheerful retail service. The fanaticism is rewarded by extraordinary sales per square foot in the stores. We greatly admire See's business methods, which have not been changed in any significant way in the seven years of our ownership. Our main managerial contribution has been to leave See's alone as its proven executives pursued its proven policies. In 1978 we paid $55 per See's share to acquire a tiny minority interest in See's. If our previously owned 99% interest in See's were valued at the same price per share, such interest would have had a total value at that time approximately $25 million more than its aggregate amortized cost in our consolidated financial statements.

WESCO FINANCIAL CORPORATION

Our equity in net income of our subsidiary, Wesco Financial Corporation (80% owned) increased to $7,417,000, a new record, compared with $5,715,000 in the previous year. The substantial improvement in Wesco's contribution was caused primarily by increased operating earnings in Wesco's savings and loan association subsidiary, Mutual Savings, headquartered in Pasadena, California. Conditions in 1978 generally favored savings and loan associations, and Mutual Savings is soundly capitalized and efficient. Wesco is a separate public corporation, with its stock listed on the American Stock Exchange. Summarized financial information for Wesco is contained in Note 1 to our consolidated financial statements and includes an exceptionally strong balance sheet, partly caused by substantial assets outside the subsidiary savings and loan association and available for commitment elsewhere. In February, 1979, Wesco purchased for approximately $15 million a midwestern steel service center business which reported after-tax earnings of $1,918,000 in the full year ended June 30, 1978. For more complete information we encourage Blue Chip shareholders to obtain a copy of Wesco's 1978 Annual Report, which embodies an unusual clarity of reporting and reflects an excellence of management—both directly attributable to Louis Vincenti, Chairman. Simply make your request to:

Wesco Financial Corporation
315 East Colorado Boulevard
Pasadena, California 91109
Attention: Mrs. Bette Deckard, Secretary & Treasurer

BUFFALO EVENING NEWS, INC.

Our 100%-owned subsidiary, Buffalo Evening News, Inc., was acquired in April of 1977 for approximately $34 million and reported, after litigaiton expenses stemming from equipment modernization, an after-tax operating loss of $1,427,000 in 1978, compared with net income of $340,000 in the portion of the previous year subsequent to acquisition.

The Buffalo Evening News had no Sunday edition when acquired; a competing paper published without opposition on Sundays. As we explained in detail in our Annual Report last year, the long-term survival or the Buffalo Evening News clearly required that it inaugurate a Sunday edition. (Real trouble has been the invariable eventual outcome for every other daily newspaper in the United States which relied overlong, in an important city, exclusively on weekday publication while a significant daily competitor enjoyed a Sunday monopoly.) Accordingly, the Buffalo Evening News

commenced publishing Sundays late in 1977. In response, a lawsuit was the competing paper which for the first time faced the prospect of competition on Sundays as well as weekdays. The lawsuit, in turn, resulted in some interlocutory (i.e., temporary and not final) injunctions (now on appeal) which, among other things, created severe disruptions in normal circulation procedures under midwinter conditions and restricted business promotion practices of our subsidiary's paper while similar but more aggressive practices of the competing paper were allowed. Despite all the difficulties; the new Sunday edition now has a steady circulation of about 156,000, up slightly in recent months. The litigation has continued through 1978, including a counter-complaint by our subsidiary as well as defense against the competing paper's complaint, causing heavy direct litigation expense and other indirect costs. Affected by these factors, plus an unanticipated decrease in weekday circulation and advertising linage (now apparently arrested), operating results at our Buffalo newspaper have, of course, been unsatisfactory.

We anticipate better operating results in the future, although we also expect that improvement in our subsidiary's competitive position in Buffalo will, at best, be extremely slow and that operating results will continue to bear heavy charges for direct and indirect expense of litigation. Newspaper readership habits ordinarily change slowly, if at all, and litigation is notoriously time-consuming, inefficient, costly and unpredictable.

The ultimate security of the Buffalo Evening News remains indoubt, as it will for a very extended period. We purchased a newspaper subject not only to the normal hazards of business competition but also to the hazards of the modern tendency of competitors to seek protection from competition In the courts.

We believe that the Buffalo Evening News remains by far the most respected newspaper in Buffalo, with a tradition of editorial objectibity and integrity and good citizenship, the result of editorial control by autonomous, community-minded local editors. We have maintained and will continue to maintain this tradition of locally-created excellence, as well as an equally important tradition of fair-dealing with all newspaper employees and unions, who have performed loyally and well to help protect our common enterprise under difficult conditions. We expect that our policies eventually will cause our newspaper subsidiary to develop into a more satisfactory investment. But a long and prosperous future is not guaranteed. If the competing paper succeeds in obtaining the kind of permanent injunctions ot is seeking, or if any extended strike shuts down the Buffalo Evening News, we believe that it will probably be forced to cease operations and liquidate, at an after-tax cost which could exceed $10 million.

TRADING STAMP AND MOTIVATION BUSINESSES

The final componenets of our consolidated new income last year were provided by our trading stamp and motivation businesses. These businesses use the same headquarters and warehousing facilities. Combined, the businesses operated at a decreased profit last year (down from $5,188,000 to $2,488,000) after (properly) giving them credit for the entire income (interest and dividends, plus income tax benefits caused by dividends, plus securities gains) from investment of the funds available through "float" caused by trading stamps issued but not yet redeemed. However, the decrease in profit was entirely attributable to a decline in securities gains from the unusully high level of 1977. Profit before securities gains increased from $1,088,000 to $1,761,000.

Trading stamp service revenues increased by a minor amount to $16,531,000 last year compared with $15,723,000 in the previous year. Motivation business revenues increased substantially, from $2,485,000 to $3,791,000.

In our trading stamp business our "float"—resulting from past issuances of trading stamps when volume was many times greater than the current level—is large in relation to current issuances. (Trading stamp revenues peaked at $124,180,000 in fiscal 1970, and our 1978 revenues of $16,531,000 therefore represented a decline of 87% from peak volume.) Eventually, unless stamp issuances improve, earning from investing "float" will decline greatly. The decline in recent years, however, has proceeded at an extremely slow rate, and our estimated future redemption liability actually increased by a tiny amount in 1978 and was $66,832,000 at yearend.

As discussed extensively in previous annual reports (particularly for fiscal 1976), which we urge shareholders to review, accounting for trading stamp redemption liability (which involves estimating the number of stamps that will ultimately be redeemed and the cost per stamp) is a difficult process under any circumstances, but particularly so in an inflationary economy and when stamp issuances decline by a large percentage. We periodically revise our estimated future redemption liability as conditions warrant.

We intend to remain in the trading stamp business. Many of our present customers, aided by our stamp service, operated

unusually successful supermarkers and other businesses, and we believe that, given the opportunity, we can also provide very useful service to new customers.

PINKERTON'S, INC.

At yearend 1978 we owned non-voting stock representing 32% of the equity in Pinkerton's, Inc., the leading national security and investigation service company. Our total investment at cost was $32,364,000.

CONSOLIDATED BALANCE SHEET AND OTHER DATA

Our consolidated balance sheet retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others. As explained in Note 4 to the accompanying financial statements, the aggregate market value of our marketable securities is slightly lower than their aggregate cost.

A section entitled "Principle Business Activities" and "Summary of Operations" for a five year period are presented beginning on page 4, followed by notes and management's discussion and analysis of the summary. We invite your careful attention to those items and to our audited financial statements.

Cordially yours,

Charles T. Munger, Chairman of the Board
Donald A. Koeppel, President

February 28, 1979

To Our Stockholders

Consolidated normal operating income (i.e., before gains from sale of securities held outside our savings and loan subsidiary) for the calendar year 1979 increased slightly, to $14,303,000 ($2.76 per share) from $13,553,000 ($2.62 per share) in the previous fiscal year.

Consolidated net income (i.e., after gains from sale of securities held outside our savings and loan subsidiary) also increased slightly, to $15,526,000 ($3.00 per share) from $14,280,000 ($2.76 per share) in the previous year.

Earnings last year were assisted by our acquisition on February 28, 1979, of a new 80%-owned subsidiary, Precision Steel Warehouse, Inc., and also by increased earnings of Mutual Savings, our 80%-owned savings and loan subsidiary. Both of these subsidiaries are wholly owned by our 80%-owned Wesco Financial Corporation subsidiary. Gains from these sources were partially offset by increased losses at our 100%-owned Buffalo Evening News subsidiary.

The Precision Steel acquisition last year has required changes in the way we present financial data. We now consolidate everything except the savings and loan subsidiary, Mutual Savings, which we continue to include on an equity basis. Formerly, all the consolidated accounts of Wesco Financial Corporation, including those dealing with assets and earnings outside Mutual Savings, were included on an equity basis. In this report, 1978 figures have been restated slightly to conform to the new presentation, with no effect on net income or retained earnings.

We have four major subsidiaries, See's Candy Shops, Incorporated (100%-owned), Mutual Savings (80%-owned), Precision Steel (80%-owned), and Buffalo Evening News, Inc. (100%-owned). If we used equity accounting instead of consolidated accounting for See's, Precision Steel's operating business, and the Buffalo Evening News as well as Mutual Savings, our consolidated income for our two reporting years just ended would break down as follows (in 000s except for per-share amounts):

Blue Chip's equity in net income (loss) of:

Year ended about	See's*1	Mutual Savings*2	Steel Business	Buffalo Evening News*3	All other net income*4,5	Blue Chip consolidated net income*5
December 31, 1979	$5,997	$6,795	$1,367	$(2,410)	$3,777	$15,526
Per Blue Chip share	1.16	1.31	.26	(.46)	.73	3.00
December 31, 1978	5,802	6,482	--	(1,427)	3,423	14,280
Per Blue Chip share	1.12	1.25	--	(.27)	.66	

- 1 After reducing income by amortization of intangibles arising from purchase of See's at a large premium over its book value
- 2 After increasing income by amortization of the discount from Mutual book value at which the interest was acquired.
- 3 After reducing income by amortization of relatively minor intangibles arising at acquisition of the newspaper in 1977.
- 4 After deduction of interest and other corporate expenses. In each year there was an operating loss from promotional services activities before residual consolidated net income was credited with (i) dividends and interest resulting from investment of the funds available through "float" caused by trading stamps issued but not yet redeemed, plus (ii) income tax benefit caused by 85% exclusion of dividends in computing federal income taxes, plus (iii) Blue Chip's share of dividends, interest and rent from securities and real estate held by the Wesco Financial Corporation group outside its saVings and loan and steel service activities, plus (iv) securities gains, net of minority interest.
- 5 The 1979 amounts include $1,223 or $.24 per Blue Chip share from securities gains, net of taxes and minority interest. In 1978 such securities gains were $727 or $.14 per Blue Chip share.

The foregoing breakdown differs somewhat from that required by the accounting conventions which govern presentation

of financial results in our audited financial statements contained elsewhere in this report. We have taken the pains to prepare it, and to furnish it in this letter, because we believe it better explains what is really happening than does our consolidated income statement in conventional form. Generally, we are trying to disclose the things we like to be told, in the form we prefer, when roles are reversed and we are passive investors.

SEE'S CANDY SHOPS, INCORPORATED

The pre-tax earnings of our 100%-owned subsidiary, See's Candy Shops, Incorporated, declined slightly last year. However, a lower income tax rate allowed a nominal percentage gain in after-tax earnings (about 3%). This result was disappointing in view of the substantial percentage gain in sales (about 19%). Comparative figures for See's for the last two years are set forth below:

Year ended about	Sales	Profits after taxes*	Number of pounds of candy sold	Number of stores open at yearend
December 31, 1979	$87,314,000	$6,473,000	23,985,000	188
December 31, 1978	73,653,000	6,289,000	22,407,000	182

- These earnings figures are a little higher than Blue Chip Stamps' share of See's earnings shown in the table above because Blue Chip's share reflects (i) deduction of the approximately 1% share of See's earnings owned by minority stockholders of See's prior to June 6, 1978, (ii) amortization of intangibles arising from purchase of See's stock at a large premium over book value. and (iii) state income taxes on See's dividends received by Blue Chip.

Boxed chocolate consumption per capita in the United States continues to be essentially static, and the candy-store business remains subject to extraordinary cost pressure. It is very difficult for See's to cope as successfully as it does with the production and distribution problems of a business with a seasonal sales peak that becomes more extreme each year, and the flat earnings trend of the last two years has not diminished our confidence in See's management, including its outstanding leader, Charles Huggins. So far as we know the candy-store business continues to be terrible to mediocre for all other companies, yet it remains quite profitable at See's for the simple reason that both new and old customers have a pronounced tendency to prefer the taste and texture of its candy, as well as the extremely high level of retailing service which characterizes its distribution. This customer enthusiasm is caused by a virtually fanatic insistence on expensive natural candy ingredients plus expensive manufacturing and distributing methods that insure rigorous quality control and cheerful retail service. These qualities are rewarded by extraordinary sales per square foot in the stores, frequently two to three times those of competitors, and by a preference by gift recipients for See's chocolates, even when measured against much more expensive brands.

In 1978 we paid $55 per See's share to acquire a tiny minority interest in See's. If our previously owned 99% interest in See's were valued at the same price per share, such interest at that time would have had a total value approximately $25 million more than its aggregate amortized cost in our consolidated financial statements.

Our best guess is that See's earnings will increase at least modestly in 1980, because of forward contracts covering most candy ingredients at fixed prices which are now below market.

MUTUAL SAVINGS AND LOAN ASSOCIATION

Our equity in net income of our 80%-owned subsidiary, Mutual Savings, increased to $6,795,000, a new record, compared with $6,482,000 in the previous year.

However, prospects for 1980 appear poor. The entire saVings and loan industry is now required to pay much higher interest rates to hold saVings accounts while assets consist primarily of low-turnover portfolios of long-term mortgages at fixed or slowly changing rates below current market. Thus our best guess is that Mutual Savings' earnings will decline sharply from the record level of 1979.

Louis Vincenti, a chief executive well past normal retirement age, has guided Mutual Savings very skillfully for many years—both before and after we acquired it—not always along the standard course chosen by others in his industry. Deviations have been toward low costs, low credit losses and high ratios of capital compared to liabilities, while net worth

has grown greatly during his tenure. Under Mr. Vincenti's mix of caution and innovation we expect Mutual Savings to continue to cope well with all challenges, including the difficulties we expect in 1980.

On March 25, 1980, just as this report and letter were going to press, Mutual Savings executed a contract with Brentwood Savings and Loan Association, a subsidiary of Jim Walter Corporation, providing for sale of all Mutual's offices except its headquarters office and a satellite thereto to be opened across the street. Closing of the contract is subject to regulatory approval. Under the terms of the contract Mutual Savings will transfer net branch office deposits (about $300,000,000), together with offsetting mortgage loans in equal amounts, and will also sell physical facilities A pre-tax gain of about $5,000,000 will be realized on the sale of physical facilities, but mortgage loans transferred will bear a higher interest rate than mortgage loans retained. It is anticipated that, after the closing: (a) a higher percentage of Mutual's total assets will consist of cash and equivalents, (b) average yield on Mutual's mortgage loans will decline significantly, and (c) Mutual's overall financial leverage will be lowered. Before or after the closing, adjustments in Mutual Savings' investments may be made, causing losses which offset part or all of any taxable profit from sale of branches; however, we do not have present plans for any such transactions. Whether, because of this sale, future earnings will be higher or lower than they otherwise would have been will depend on factors impossible now to predict, including future interest rates and future changes in laws and regulations affecting savings institutions. The proposed sale reflects a desire to restructure operations of Mutual Savings, which will continue in the savings and loan business.

PRECISION STEEL WAREHOUSE, INC.

Our 80%-owned Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, was acquired for approximately $15 million on February 28, 1979. It owns a long-established steel service center business and a subsidiary engaged in distribution of tool room supplies and other products sold under its own brand names. Precision Steel's operating businesses contributed $1,367,000 to our consolidated net income in 1979, on combined sales of $37,510,000, in the 10 months of our ownership. Precision Steel is led by David Hillstrom, a chief executive who has served the company for almost 30 years.

A steel service center business may strike some of our shareholders as a peculiar addition to a candy company, even one already joined to a savings and loan business. However, Precision Steel shares an extremely important quality with See's: a company-wide culture of constant concern for customer interests and fair dealing. We believe such quality, if maintained, in a business with at least reasonably attractive economic characteristics, will almost always produce good long-term business results and, accordingly, are optimistic about the future of our new subsidiary.

Both Mutual Savings and Precision Steel are owned by Blue Chip Stamps through 80% control of Wesco Financial Corporation, a public company with shares traded on the American Stock Exchange. For more complete information, we encourage Blue Chip shareholders to obtain a copy of Wesco's 1979 annual report. Simply make your request to:

Wesco Financial Corporation
315 East Colorado Boulevard
Pasadena, California 91109
Attention: Mrs. Bette Deckard, Secretary & Treasurer

BUFFALO EVENING NEWS, INC.

Our 100%-owned subsidiary, Buffalo Evening News, Inc., was acquired in April 1977 for approximately $34 million. Its reported financial results continue to be adversely affected by litigation expenses, increased depreciation and extraordinary expenses of "buy-outs" from labor contract provisions made in order to allow the News to benefit from equipment modernization. So affected, the after-tax operating loss was $2,410,000 in 1979, compared with a lower after-tax operating loss of $1,427,000 in the previous year.

However, some developments were quite favorable: (1) The position of the News in pending litigation with a daily newspaper competitor was supported by a unanimous and strongly worded decision of the Federal Court of Appeals in New York, reversing interlocutory injunctions which had interfered greatly with normal competitive operation of the News; (2) Circulation of the Sunday edition of the News has been rising steadily; (3) The "buy-outs" of labor contract provisions made in 1979 are expected to cause substantial cost reductions in following years; and (4) The owners of the competing Buffalo newspaper, who were responsible for commencing the pending litigation, sold their newspaper to the Minneapolis Star and Tribune Company, which shortly thereafter raised advertising rates by about 10%, thus reducing

the pricing pressure applied by the previous owners who made a practice, after initiation of the News' Sunday edition, of increasing advertising rates by amounts far below inflation rates.

We now believe that the worst may be behind us in Buffalo, but we retell and extend the history so that shareholders can make their own judgments.

The News had no Sunday edition when acquired. The principal competitor, the Buffalo Courier-Express, published without opposition on Sundays. As we explained in detail in our 1977 and 1978 annual reports, the long-term survival of the News clearly required that it inaugurate a Sunday edition. (Of that there was simply no question. Real trouble has been the invariable eventual outcome for every other daily newspaper in the United States which relied overlong, in an important city, exclusively on weekday publication while a significant seven-day competitor enjoyed a Sunday monopoly. In fact, only three other "no-Sunday" papers, competing against such "with-Sunday" papers in important cities, survived as late as 1977, even though many such "no-Sunday" papers once had long histories of profitability derived from dramatic advantages in weekday circulation and advertising over their "with-Sunday" competitors. And since then one of the three survivors, the Cincinnati Post, has been preserved, after incurring huge losses, only through the grace of its competitor's absorbing it into a joint operation with approval of the U. S. Attorney General as required by the Federal Newspaper Preservation Act of 1970. Unless similar government-blessed joint operations occur, the other two surviving "no-Sunday" papers, the Cleveland Press and the New York Post. now appear almost surely doomed by apparently irreversible operating losses.) Under such circumstances, the News commenced publishing Sundays late in 1977, as it plainly had to do if it cared at all about its long-term future. In response, an antitrust lawsuit was filed by the competing paper which for the first time faced the prospect of competition on Sundays as well as weekdays. The lawsuit, in turn, resulted in some interlocutory (i.e., temporary and not final) injunctions which, among other things, created severe disruptions in normal circulation procedures under midwinter conditions and restricted certain business promotion practices of the News, commonplace within the newspaper industry, while similar but more aggressive practices of the competing paper were not prohibited. As above set forth, these interlocutory injunctions were reversed on appeal in 1979.

In its unanimous decision for reversal of the injunctions, the Federal Court of Appeals reasoned that the generally pro-competitive antitrust laws should not be used in an anti-competitive fashion by enjoining normal promotional practices, such as those used by the News, in the course of normal competition such as inauguration of a Sunday edition.

Of course, elimination of the harmful interlocutory injunctions does not automatically improve circulation and advertising lineage of the News' Sunday edition. Success in the market has to be won slowly, if it can be won at all, through creating a desirable value for customers. Moreover, achieving success has been made more difficult by the fact that it was beyond the power of the appellate court to reverse certain material damages to the News caused by the interlocutory injunctions and accompanying publicity. But some success is occurring despite the damaged beginning. The News' Sunday edition is now being recognized by subscribers for editorial merit and is being rewarded by a steady circulation growth, tending to close the lead enjoyed by the Sunday Courier-Express. Great credit must be given to Murray Light, Editor of the News, for consistent delivery of a product which deserves and has received increased acceptance by the Greater Buffalo community. The circulation of the News' Sunday edition reached approximately 173,000 copies in February, 1980, up from approximately 156,000 copies in February, 1979, with strength accelerating throughout the period. On weekdays circulation has also increased, and the weekday News continues to be greatly preferred to the weekday Courier-Express by both readers and advertisers.

Meanwhile, notwithstanding the decision in favor of the News by the Federal Court of Appeals, pre-trial proceedings in the ligitation with the Courier-Express have continued under supervision of the trial court through 1979, including discovery proceedings related to both a counterclaim by our subsidiary and a number of defenses against the competing paper's complaint, causing heavy direct litigation expenses and other indirect costs and detriments. Influenced by these factors, operating results at our Buffalo newspaper quite naturally remained unsatisfactory in 1979.

And even though signs are quite encouraging, causing us to anticipate better operating results in the future, the ultimate security of the Buffalo Evening News remains in doubt, as it will for a very extended period.

The evidence seems clear that the Buffalo Evening News is by far the most respected newspaper in Buffalo, with a tradition of editorial objectivity and integrity and good citizenship, the result of editorial control of autonomous, community-minded local editors. We have maintained and will continue to maintain this tradition of locally created excellence, as well as an equally important tradition of fair dealing with all newspaper employees and unions, who have

performed loyally and well to help protect our common enterprise under difficult conditions. But even with such policies and position a long and prosperous future is not guaranteed. If the litigation continues and if the competing paper succeeds in somehow changing the law as enunciated by the Federal Court of Appeals and in obtaining the kinds of injunctions it is seeking, or if any extended strike shuts down the Buffalo Evening News, it will probably be forced to cease operations and liquidate, at an after-tax cost which could exceed $10 million. We don't think either of the possible causes for permanent closedown is likely to occur but believe our shareholders should be made aware of the hazard.

And as the hazard recedes, it should be emphasized that the News remains a valuable asset, with journalistic habits which should serve it well in the continuing competition.

Under its long-time editor, Alfred H. Kirchhofer, who still comes to the News every day at age 87, the paper developed many desirable practices, large and small, which contribute to our optimism. For instance, it became well known among journalists for the intensity with which'it insisted that names, including middle initials, always be exactly correct in News' stories. "If you don't get the reader's own name right," asked Kirchhofer, "why should he believe you are correct in whatever else you report?" It is said that an institution is often the lengthened shadow of a single man. That seems to be true at the News where we regard Murray Light as a fit successor to Kirchhofer, preserving his basic value system while continuing to improve the paper.

At Blue Chip Stamps we are in part engaged in the business of trying to invest in the lengthened shadows of the right sort of people. We think we did so in Buffalo and that better financial results will probably be obtained in due course as we earn such results through nurture of a type of accurate, reader-oriented journalism unlikely to go out of style.

We do find quite irritating one aspect of the situation in Buffalo. Possibly because of the recent sale of the competing paper by its former owners and because our distaste for operating losses is so obvious to all observers, we are plagued by occasional rumors that we intend to sell the Buffalo Evening News. We do not intend to sell and will not sell. Our policy is to improve and hold.

PROMOTIONAL SERVICES BUSINESS AND OTHER INCOME

The final components of our consolidated net income last year were provided by (1) earnings from our promotional services (mainly trading stamp and motivation) business, after deduction of interest and other general parent company expense, plus (2) our share of earnings, after deduction of interest and other Wesco general corporate expense, from securities and real estate held by Wesco outside the savings and loan and steel service activities of its subsidiaries.

The promotional services business operated at a slightly decreased profit, after parent company interest and other general expense and taxes, last year, down from $2,488,000 to $2,392,000, after (properly) giving it credit for the entire income (dividends and interest, plus income tax benefits caused by dividends, plus securities gains) from investment of the funds available through "float" caused by trading stamps issued but not yet redeemed. The decrease in profit was attributable to increased interest expense.

Trading stamp service revenues decreased by a minor amount to $15,967,000 last year compared with $16,531,000 in the previous year. Motivation business revenues decreased substantially from $3,791,000 to $2,310,000.

In our trading stamp business our "float"—resulting from past issuance of trading stamps when volume was many times greater than the current level—is large in relation to current issuances. (Trading stamp revenues peaked at $124,180,000 in fiscal 1970, and our 1979 revenues of $15,967,000 therefore represented a decline of 87% from peak volume.) Eventually, unless stamp issuances improve, earnings from investing "float" will decline greatly. The decline in recent years, however, has proceeded at an extremely slow rate, and our estimated future redemption liability actually increased by a tiny amount in 1979, as it also did in the previous year, and was $67,524,000 at yearend 1979.

As discussed extensively in previous annual reports (particularly for fiscal 1976), which we urge shareholders to review, accounting for trading stamp redemption liability (Which involves estimating the number of stamps that will ultimately be redeemed and the cost per stamp) is a difficult process under any circumstances, but particularly so in an inflationary economy and when stamp issuances decline by a large percentage. We periodically revise our estimated future redemption liability as conditions warrant.

We intend to remain in the trading stamp business. Many of our present customers, aided by our stamp service, operate unusually successful supermarkets and other businesses, and we believe that, given the opportunity, we can also

provide very useful service to new customers.

One final item augments our consolidated net income. Our share of earnings, including securities gains but after deduction of interest and other Wesco general corporate expense, from securities and real estate held by Wesco outside the savings and loan and steel service activities of its subsidiaries. amounted to $1,385,000 in 1979, compared with $935,000 in the previous year.

PINKERTON'S, INC.

At yearend 1979 we owned non-voting stock representing 34% of the equity in Pinkerton's, Inc., the leading national security and investigation service company. Our total investment at cost was $23,364,000. Only the dividends we receive from Pinkerton's are included in our reported income.

CONSOLIDATED BALANCE SHEET AND OTHER DATA

Our consolidated balance sheet retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others. As explained in Note 4 to the accompanying financial statements, the aggregate market value of our marketable securities was higher than their aggregate cost at December 29, 1979 and approximately equal to such cost at March 17, 1980.

We did add $25,000,000 in long-term debt to our consolidated balance sheet last year, representing 12-year 10 1/8% notes sold in a public issue by our 80%-owned Wesco Financial Corporation subsidiary to pay for the Precision Steel acquisition and in anticipation of other needs. However, even after this issue of long-term notes, we remain in a conservative position when total debt is compared to total net worth and total liquid assets.

A section entitled "Principal Business Activities" and a "Summary of Operations" for a five-year period are presented beginning on page 7, followed by notes and management's discussion and analysis of the summary. We invite your careful attention to those items and to our audited financial statements.

A LOOK BACK AND A LOOK AHEAD

We began the last decade with a single business, trading stamps, which was destined to decline by 87%, and a portfolio of securities, offsetting stamp redemption liabilities, which had been selected by previous owners and would have created a perfect disaster if held through to the present time. (The portfolio, for instance, contained a substantial amount of very-long-term, low-coupon municipal bonds of issuers with declining credit ratings.) Starting with this shaky foundation, the Company has managed to earn an average, although fluctuating, return of about 15% per annum on its stockholders' equity over the years. The 15% return, while not outstanding, is respectable when achieved with a balance sheet position as conservative as ours and from such a poor starting position.

So far, the 1980s appear likely to present at least as many challenges as the 1970s, but we expect to use our balance sheet strength over the next 10 years, as we did in the last 10 years, to acquire additional businesses, and we hope to earn, on average, an even higher percentage return on our shareholders' investment. One cause of our hope for a higher return is our recognition of how many mistakes we made in the course of earning 15% on equity in the decade just past. There is plenty of room for improved decision-making, and we intend to improve if we can.

However, if the present inflation continues at double-digit rates through the 1980s, real investment returns for our shareholders may well be disappointing, even if we rank well among American corporations in terms of annual earnings expressed as a percentage of shareholders' equity. A 16% return on equity, for instance, obviously won't do much in real terms for shareholders if the inflation rate is 16%, or even 11% when we also allow for income taxes imposed on owners who must report taxable "profits" while only maintaining their position on the purchasing-power treadmill. We remind shareholders of this truism because we want them to know that we are not deluded by historically satisfactory numbers into believing all is well for them. It seems likely to us that a habit of always thinking about shareholders' interests in real terms may ultimately create some sort of plus factor in our stewardship.

Cordially yours,

Charles T. Munger, Chairman of the Board

Donald A. Koeppel, President

March 25, 1980

To Our Stockholders

Consolidated operating income (i.e., before all net gains from sales of corporate securities and important fixed assets) for the calendar year 1980 increased to $16,564,000 ($3.20 per share)from $14,312,000 ($2.76 per share) in the previous year.

Consolidated net income (i.e., after net gains from sale of corporate securities and important fixed assets) increased to $20,389,000 ($3.94 per share) from $15,526,000 ($3.00 per share) in the previous year.

We have four major subsidiaries, See's Candy Shops, Incorporated (100%-owned), Mutual Savings (80%-owned), Precision Steel (80%-owned), and Buffalo Evening News, Inc. (100%-owned), in addition to the basic business (primarily trading stamps) operated by the parent company. Our consolidated income for our two reporting years just ended breaks down as follows (in 000s except for per-share amounts):

Year ended about	See's*1	Mutual Savings*2	Steel Business	Buffalo Evening News*3	All other net income*4	Net gains on sales of securities & fixed assets*5	Blue Chip consolidated net income
December 31, 1980	$7,270	$4,181	$1,205	$(1,472)	$5,380	$3,825	$20,389
Per Blue Chip share	1.40	.81	.23	(.28)	1.04	.74	3.94
December 31, 1979	5,997	6,804	1,367	(2,410)	2,554	1,214	$15,526
Per Blue Chip share	1.16	1.31	.26	(.46)	.49	.24	3.00

- 1 After reducing income by amortization of intangibles arising from purchase of See's at alarge premium over its book value.
- 2 After increasing income by amortization of the discount from Mutual book value at which the interest was acquired.
- 3 After reducing income by amortization of relatively minor intangibles arising at acquisition of the newspaper.
- 4 After deduction of interest and other corporate expenses. In each year there was an operating loss from promotional services activities before residual consolidated net income was credited with (i) dividends and interest resulting from investment of the funds available through "float" caused by trading stamps issued but not yet redeemed, plus (ii) income tax benefit caused by 85% exclusion of dividends in computing federal income taxes, plus (iii) Blue Chip's share of dividends. interest and rent from securities and real estate held by the Wesco Financial Corporation group outside its savings and loan and steel service activities, plus (iv) in 1980 a net adjustment of Blue Chip's stamp liability account in the amount of $1,747 or $.34 per Blue Chip share, net of taxes, as explained below under "Promotional Services Business and Miscellaneous Sources of Operating Income."
- 5 The 1980 figures comprise $2,332 or $.45 per Blue Chip share attributable to Mutual's sale of 15 branch offices, as explained below under "Mutual Savings and Loan Association," and $1,493 or $.29 per Blue Chip share of net securities gains realized by the various entities including Mutual, net of taxes and minority interest. The 1979 figures relate solely to such net securities gains.

The foregoing breakdown (of the same aggregate earnings) differs somewhat from that used in (1) our letter to shareholders last year, and (2) our audited financial statements.

We have taken the pains to prepare our unconventional breakdown of earnings and to furnish it in this letter because we belleve it better explalns what is really happening than does our accompanying consolidated income statement in conventional form. Generally, we are trying to improve our annual letter to shareholders each year so as better to disclose the things we would want to be told if the roles were reversed and we were passive investors.

SEE'S CANDY SHOPS, INCORPORATED

The earnings of our 100%-owned subsidiary, See's Candy Shops, Incorporated, increased 19.7% last year. This was a welcome change from nominal increases in earnings which occurred in the two previous years. Comparative figures for See's last four years are set forth below:

Year ended about	Sales	Profits after taxes*	Number of pounds of candy sold	Number of stores open at yearend
December 31, 1980	$97,715,000	$7,747,000	24,065,000	191
December 31, 1979	87,314,000	$6,473,000	23,985,000	188
December 31, 1978	73,653,000	6,289,000	22,407,000	182

- These earnings figures are a little higher than Blue Chip Stamps' share of See's earnings shown in the table above because Blue Chip's share reflects (i) deduction of the approximately 1% share of See's earnings owned by minority stockholders of See's prior to June, 1978, (ii) amortization of intangibles arising from purchase of See's stock at a large permium over book value, and (iii) state income taxes on See's dividends recieved by Blue Chip.

Boxed chocolate consumption per capita in the United States continues to be essentially static, and the candy-store business remains subject to extraordinary cost pressures. When See's increases prices to reflect these cost pressures it never knows whether consumer resistance will cause net profits to fall instead of rise. Thus far, consumers have been willing to keep buying in the amounts required to keep See's profits rising at a moderate rate, but a continuation of this state of affairs logically cannot continue forever if See's costs keep increasing faster than the general rate of inflation.

Perhaps because price increases deter purchases for personal consumption more than purchases for gifts, See's seasonal sales peak becomes more extreme each year, causing many operating problems and a growing concentration of See's net income into the single month of December. Nonetheless, See's continues to make moderate average yearly progress under its outstanding leader, Charles Huggins.

So far as we know the candy-store business continues to be terrible to mediocre for all other companies, yet it remains quite profitable at See's, despite all the problems, for the simple reason that both new and old customers have a pronounced tendency to prefer the taste and texture of its candy, as well as the extremely high level of retailing service which characterizes its distribution. This customer enthusiasm is caused by a virtually fanatic insistence on expensive natural candy ingredients plus expensive manufacturing and distributing methods that ensure rigorous quality control and cheerful retail service. These qualities are rewarded by truly extraordinary sales per square foot in the stores, frequently two to three times those of competitors, and by a preference by gift ,recipients for See's chocolates, even when measured against much more expensive brands.

In 1978 we paid $55 per See's share to acquire a tiny minority interest in See's. If our previously owned 99% interest in See's were valued at the same price per share, such interest at that time would have had a total value approximately $25 million more than its aggregate amortized cost in our consolidated financial statements.

Our guarded forecast is that See's earnings will increase at least modestly in 1981.

MUTUAL SAVINGS AND LOAN ASSOCIATION

In last year's letter to shareholders we made the following prediction regarding our 80%-owned subsidiary, Mutual Savings:

> "Prospects for 1980 appear poor. The entire savings and loan industry is now required to pay much higher interest rates to hold savings accounts while assets consist primarily of low-turnover portfolios of long-term mortgages at fixed or slowly changing interest rates below current market. Thus our best guess is that Mutual Savings' earnings will decline sharply from the record level of 1979."

We also reported last year that Mutual Savings had contracted to sell, to Brentwood Savings and Loan Association all its offices except its headquarters office and satellite thereto directly across the street. As predicted, and for the reason predicted, our equity in Mutual Savings' operating income declined sharply in 1980 to $4,181,000 from $6,804,000 ih the

previous year.

The sale of Mutual Savings' branch offices closed December 1,1980, after all regulatory approvals had been obtained, pursuant to the contract with Brentwood Savings.

The financial leverage of Mutual Savings, and the proportion of its assets not in cash and equivalents and marketable securities, were greatly reduced by the sale of the branch offices. These changes are evident when one compares the condensed balance sheets of Mutual Savings at December 31, 1980, and at December 31, 1979, set forth below:

ASSETS	**December 31, 1980**	**December 31, 1979**
Cash	$2,182,000	$2,744,000
Receivables, including accruals	2,580,000	6,070,000
Interest-bearing cash equivalents	73,982,000	54,239,000
Marketable securities	27,395,000	45,118,000
Loans on real estate, including participations	156,438,000	481,395,000
Office property	291,000	2,679,000
Other assets	9,630,000	9,361,000
	$272,498,000	$601,606,000
LIABILITIES AND NET WORTH		
Accounts payable, including accruals	$11,422,000	$11,318,000
Savings accounts, net of loans on the security thereof to savers [*1]	169,237,000	484,925,000
Notes payable to Federal Home Loan Bank	43,382,000	48,626,000
	224,041,000	544,869,000
Total capital and surplus (virtually all in reserves, withdrawal of which would cause imposition of income taxes)[*2]	48,457,000	56,737,000
	$272,498,000	$601,606,000

- 1 Includes $8,944,000 deposited by parent company in 1980 and $1,667,000 in 1979.
- 2 The lower capital and surplus in 1980 results from dividends paid to the parent company.

Real estate loans, before the sale of branch offices, were earning at an average annual interest rate of approximately 9.33%. Late in December, after the sale, the average annual interest rate being earned on the retained residue of real estate loans had been reduced to approximately 7.68%. The reduction occurred because most of the loans sold were from the highest-earning part of the pre-existing portfolio.

The income-reducing-effects of these low-interest-rate retained loans, so long as interest rates are roughly at their current level, will be more than offset by the income-increasing effects of (1) the high after-tax yields from other retained assets and (2) the elimination of all revenues and costs attributable to the branch offices, with the result that both Mutual Savings' average gross return on assets and its net earnings should be a little higher than they would have been had no sale of branch offices occurred.

However, if interest rates decline significantly and more or less permanently, aggregate future earnings will be much lower than would have been reported without the sale of branch offices. On the other hand, if, some time within the next few years, inflation and interest rates rise significantly and more or less permanently, the sale of branch offices will much improve aggregate future earnings. Thus Mutual Savings has taken action designed to protect itself from adverse effects of high inflation rather than action to position itself for maximum profit from low inflation. The action taken was not based on the belief that high inflation and-high interest rates in the future are inevitable, or even more likely than not. Instead the action reflects a desire, motivated by the margin-of-safety considerations intrinsic in engineering and still appropriate, we think, in financial institutions, to restructure Mutual Savings so that a sort of "earthquake risk" was reduced.

This "earthquake risk" was that at some future time interest rates would rise to such an extent that net operating losses might be created by a negative spread between interest rates on old, fixed-interest mortgage loans and the interest rates which would have to be paid to hold savings accounts. The savings and loan industry, with Mutual Savings included, has traditionally "lent long and borrowed short," to an extreme degree. The extremism worked well for decades but has not been wise in recent years. We should have learned this lesson earlier.

As part of the sale of the branch offices, the fixed assets (primarily real estate) of such offices were sold to the buyer at their current market value, which exceeded Mutual Sayings' depreciated cost. Our equity in the capital gain thus created was $2,332.000 and is included in the portion of earnings designated in this letter under the heading "Net Gains From Sales of Securities and Important Fixed Assets."

It is not pleasant work for a savings and loan association, motivated by a prudent concern for its shareholders and a desire to retain unquestioned financial strength, to sell off its carefully developed branch office network and see many of its long-term employees leave, even when they join a high-class organization like Brentwood Savings. Louis Vincenti, long-time chief executive of Mutual Savings, performed this unpleasant duty well, as he has every other duty in a long and successful career.

Mutual Savings plans to continue indefinitely in the savings and loan business, under Mr. Vincenti's able leadership so long as he is willing to serve. The savings and loan business is currently in considerable turmoil, not only because of generally poor operating results attributable to a combination of a high interest-rate environment with a borrowed-short, lent-long position, but also because the distinctions between banks and savings and loan associations are being reduced and the regulatory framework revised to increase competitive pressures. We expect Mutual Savings to adapt successfully to the new environment in some manner not presently predictable, which could even include eventual re-expansion by acquisition.

PRECISION STEEL WAREHOUSE, INC.

Our 80%-owned Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, was acquired for approximately $15 million on February 28,1979. It owns a long-established steel service center business and a subsidiary engaged in distribution of tool room supplies and other products sold under its own brand names, Precision Steel's operating businesses contributed $1,205,000 to our consolidated net income in 1980 from 12 months of operation compared with $1,367,000 in 1979 from 10 months of operation. The decline in earnings was roughly consonant with general conditions in the steel industry.

Both Mutual Savings and Precision Steel are owned by Blue Chip Stamps through 80% control of Wesco Financial Corporation, a public company with shares traded on the American Stock Exchange. For more complete information, we encourage Blue Chip shareholders to obtain a copy of Wesco's 1980 annual report. Simply make your request to:

Wesco Financial Corporation
315 East Colorado Boulevard
Pasadena, California 91109
Attention: Mrs. Bette Deckard, Secretary & Treasurer

BUFFALO EVENING NEWS, INC.

Our 100%-owned subsidiary, Buffalo Evening News, Inc., was acquired in April 1977 for approximately $34 million. It now constitutes only approximately $29 million of our consolidated net worth, as a result of about $5 million of aggregate after-tax operating losses after acquisition. This translates roughly into $1 aggregate operating losses before taxes.

However, the operating loss, before taxes, of the News in 1980 was lower than that of 1979, having declined to $2,805,000 from $4,617,000 in the previous year.

In our letter to shareholders last year we reported that "financial results continue to be adversely affected by litigation expenses, increased depreciation and extraordinary expenses of 'buy-outs' from labor contract provisions made in Order to allow the News to benefit from equipment modernization," and that "we now believe that the worst may be behind us in Buffalo . . ."

In 1980 the Buffalo Evening News experienced a continuation of all the above-listed factors which caused losses in previous years, plus two new factors: (1) Buffalo's greater-than-proportionate share of the national economic recession and (2) the first labor strike at the News since 1970, when publication was very briefly interrupted by a labor dispute, creating the only such interruption before last year which anyone now at the News can remember. Nonetheless, the operating loss did decrease as predicted and as above noted.

It is, of course, a temptations when writing an annual letter to shareholders to gloss over difficulties, like those in Buffalo, and comment extensively converning successes. We recommend exactly the opposite emphasis to business managers who report to us, and we believe in practicing what we preach. Accordingly, year after year, we re-tell and extend the history of the News, creating the largest single section of our annual letter. This year will be no exception.

The News had no Sunday edition when acquired. The principal competitor, the Buffalo Courier-Express, published without opposition on Sundays. As we explained in detail in our 1977 through 1979 annual reports, the long-term survival of the News clearly required that it inaugurate a Sunday edition. [Of that there was simply no question. Real trouble has been the invariable eventual outcome for every other daily newspaper in the United States, no matter how extreme its past record of prosperity and popularity, which relied overlong, in an important city, exclusively on weekday publication while a significant seven-day competitor enjoyed a Sunday monopoly, In fact, only three other "no-Sunday" papers, competing against such "with-Sunday" papers in important cities, survived as late as 1977, even though many such 'no-Sunday" papers once had long histories of profitability derived from dramatic advantages in weekday circulation and advertising over their "with-Sunday" competitors. Moreover, the three other survivors all were in serious trouble in 1977. And since then one of the three survivors, the Cincinnati Post, has been preserved, after incurring huge losses, only through the grace of its competitor's absorbing it into a minority share of a joint operation with approval of the U.S. Attorney General as required by the Federal Newspaper Preservation Act of 1970. A second of these "no-Sunday" survivors of 1977, the Cleveland Press, after also incurring huge losses, was recently sold by its experienced Ohio-based newspaper-chain owner (Scripps-Howard), under distress conditions, to a wealthy Cleveland man who forthwith announced that his resuscitation program included a plan to expend many millions of dollars in an attempt to publish Sundays as well as weekdays. Because of continuing and apparently irreversible operating losses, the Cleveland Press appears almost surely doomed, despite its belated recognition of the cause of its difficulty, as does what will shortly be the only remaining "no-Sunday" survivor, the New York Post. And, within a few years, when this last survivor disappears, the "no-Sunday" paper, competing in an important American city against a "with-Sunday" competitor, will be as extinct as the dodo bird.]

Under such circumstances, the News commenced publishing Sundays late in 1977, as it plainly had to do if it cared at all about its long-term future. In response, an antitrust lawsuit was filed by the competing paper which for the first time faced the prospect of competition on Sundays as well as weekdays. The lawsuit, in turn, resulted in some interlocutory (i.e., temporary and not final) injunctions which, among other things, created severe disruptions in normal circulation procedures under midwinter conditions and restricted certain business promotion practices of the News, commonplace within the newspaper industry, while similar but more aggressive practices of the competing paper were not prohibited.

These interlocutory injunctions against the News were reversed on appeal in 1979. In its unanimous decision for reversal of the injunctions, the Federal Court of Appeals reasoned that the generally pro-competitive antitrust laws should not be used in an anti-competitive fashion by enjoining normal promotion practices, such as those used by the News, in the course of normal competition such as inauguration of a Sunday edition.

Of course, the elimination of the harmful interlocutory injunctions did not automatically improve the circulation and advertising linage of the News’ Sunday edition. Success in the market had to be won slowly, if it could be won at all, through creating a desirable value for customers. Moreover, achieving success was made more difficult by the fact that it was beyond the power of the appellate court to reverse certain material damage on an infant at birth impairs its subsequent life even after the people in charge of the operating room have decided that different delivery procedures would have been appropriate.

Despite the damage at birth, there was a gradual trend towards success. The Sunday edition of the News has been recognized by subscribers for editorial merit and rewarded by steady circulation growth, needed considering the substantial Sunday-circulation lead of its principal competitor. Great credit must be given to Murray Light, Editor of the News, and other editors and reporters, for consistent delivery of a product which deserves and has received increased acceptance by the Greater Buffalo community. The circulation of the News' Sunday edition reached approximately 178,000 copies in February 1981, up from approximately 173,000 copies in February 1980 which, in turn, was up from

156,000 copies in February 1979. Weekday circulation has also increased in 1980, as it did in 1979, and the weekday News continues to be greatly preferred to the weekday Courier-Express by both readers and advertisers.

However, the 1980 gains which occurred in both the Sunday and the weekday circulation of the News were not accompanied by declines in either the weekday or the Sunday circulation of the competing Courier-Express, both of which also increased. Thus Buffalo, suffering more than its share of a national recession, nonetheless saw circulation of every edition published by its two competing major newspaper operations increase last year, exactly as one might expect in a boom city in an oil-saturated Sunbelt state like Texas. The twin gains on Sunday were particularly impressive. This every-edition-of-each-paper circulation growth obviously can't occur each year in the future if such growth remains inconsistent, as it was last year, with national and regional trends. Aggregate weekday circulation in Buffalo may well decline at some point as circulation prices increase and/or promotional efforts decrease in response to business conditions. Aggregate Sunday circulation is likely to continue to increase, reflecting the overwhelming and growing relative importance of Sunday newspapers.

The News' share of the total advertising linage of the two major newspaper operations in Buffalo increased very slightly in 1980, to about 59.6%. The increase in the News' share would have been greater, except for its strike which prevented publication and shifted business to its competitor on two big advertising days shortly before Christmas.

The News, and presumably the competing Courier-Express as well, lost money last year despite very substantial increases in prices forced by economic pressure. Overall, this situation is not desirable for employees or shareholders. And labor relations are affected in a none-too-predictable fashion when employers are unable to incur additional costs without bearing unacceptable losses.

Approximately 83% of the News' employees are members of its 13 different labor unions which through bargained settlements over many years have helped create collective bargaining agreements some of which contain provisions, designed to save jobs, which prevent technological change. With occasional exceptions, all in recent years, as each new collective bargaining agreement was negotiated the union involved sought to improve, from its own point of view, on the expiring collective bargaining agreement, with the net effect that (1) the newspaper was often left weaker on account of inefficient operations and (2) there was often some leapfrogging of benefits, giving a particular union more than its proportionate share of aggregate available economic advantage.

By the time Blue Chip Stamps purchased the News in 1977, this process, combined with a similar process at the Courier-Express and the general state of the newspaper business in Buffalo, had greatly reduced profits of both newspapers. In fact, profits were so minimal that unless more rapid technological progress were allowed and the leapfrogging process ended in favor of conservative pattern settlements, one of the two major newspapers eventually would be forced to cease publication, as has happened in response to similar pressures in major city after major city, on both sides of the Atlantic. In recognition of these facts, the Courier-Express in the years immediately preceding 1977 obtained needed union concessions and suffered no strikes.

There were also grounds for optimism concerning labor relations at the News. We believed in 1977 when we purchased the News that the enterprise-destroying pattern of labor relations which had killed so many metropolitan newspapers was unlikely to kill the News in Buffalo. For one thing, the News had an up-from-the-ranks labor-relations executive, Richard Feather, whom we instantly admired and trusted as fair-minded and constructive and perceived as likely to be so regarded by union members at the News. For another, we made a point, before closing the acquisition, of meeting some of the union leaders and their counsel, and they likewise impressed us favorably. Further, we noticed a great professionalism in employees at the News. Production people and reporters alike cared about the quality of their product, causing us to conclude that they would care similarly about the security and continuation of a common enterprise. Still further, we perceived a high level of friendship and communication among employees of the News, across craft-union lines. Indeed, the enterprise is so old and its jobs so well regarded that jobholders of all kinds have for decades urged their relatives and friends to join the News, often in different craft unions, creating as the years went by something more like a family business than might seem possible to anyone not familiar with it. Finally, we had enjoyed constructive relations with diverse and major labor unions elsewhere and did not enter Buffalo with any plan to seek destruction of long-established benefits, although we did hope to use negociated voluntary “buy-outs” to make some particularly important reductions in future costs. All these factors, together with the News’ long history of labor peace, contributed to our willingness to purchase the News, although at least two other prospective buyers, perhaps more fearful of the risks from having an unusually large number of separate unions, had refuse to pay the asking price for the paper.

Until 1980 the long no-strike history continued much as we expected, despite economic forces and troubles which frequently caused operating losses for the News and disappointing wage and salary increases for union members and other employees.

However, with 13 different unions and serious external pressures from competition and inflation, labor peace requires that 14 different groups (the News' management plus all 13 unions), without any exception, understand well the common danger, and, even if moving backward in inflation-adjusted economic terms, be wise and considerate of one another at all times. Even in the presence of the unusually favorable conditions for labor peace at the News, such unanimous wisdom and restraint are a lot to expect, given (1) the limitations of human nature, including that on management's side of the table, (2) the tradition, carried over from a different era, at each union that its main preoccupation should be vigorously to enhance and protect the interests of its own members, and (3) the fact that technological changes do not arrive at a steady pace and with effects allocated equally to each union.

The long labor peace ended in December 1980, when one small union group went on strike in an effort to insert new manning requirements, and new requirements of pay for work even if not performed, into its collective bargaining agreement. Most of the other unions' members, recognizing the pattern-breaking nature of the striking union group's demands, ignored a picket line and reported for work, but, finally, most of the News' pressmen refused to continue working, and the News was unable to continue publishing.

The gravity of the strike, its harmful effect on the potentiality for continued existence of the News, can hardly be overstated. An area-wide metropolitan newspaper which is closed down by a strike while a similar competitor continues publishing does not merely lose a lot of money while the strike goes on and then return to publishing at approximately the same annual profit (or loss) as before. Instead, because the competing paper gains circulation rapidly during the strike, the closed-down paper usually suffers such a loss of competitive position that it fairly soon reaches a point where it is unwise to reopen at all. For instance, in Montreal what had long been the overwhelmingly dominant English-language newspaper recently lost many millions of dollars, before its ultimate expiration, in a fruitless and foolish attempt to reopen after a strike of several months during which its main competitor continued to publish.

Such being the facts of life, the News had no practicable alternative, when its strike occurred last year, except to prepare to face rationally whatever degree of impaired position resulted from the strike. Clearly, if the strike was an extended one, the sensible decision would be not to renew publication. Nor was the News willing to settle its disagreement with the striking union group in any manner unfair to other unions involved, under conditions of common external hazard, in serial bargaining of union contracts. A resolution of the dispute unfair to unions which had settled earlier would lead to a ruinous resumption of leapfrogging to the ultimate detriment of the News and all its employees, including those attempting to take the first jump.

Fortunately, the amount of good will and good sense at the News was sufficient, as the matter worked out, to cause the strike to end in two days without, in the News' view, unfairness to unions which had settled earlier. However, the strike augmented the News' pre-tax losses by several hundred thousand dollars and also caused a small loss of competitive position. Both economic results, of course, diminish the capacity of the News to compensate its employees in the future as well as its prospects for beginning to pull its economic weight for shareholders.

The litigation against the News, filed by the Courier-Express in 1977 when the News commenced publishing on Sundays, remains pending. However, the litigation has been less active and costly in 1980, following purchase of the Courier-Express by the Minneapolis Star and Tribune Company, which has a history of preferring the exercise of business and journalistic skills over court battles. On the other hand, possibly as a result of this preference, the Courier-Express is now a more effective competitor that it was under its former owners.

Encouraged by the News' reduced operating loss in 1980, despite the strike and Buffalo's depressed economy, we expect a further improvement in operating results in 1981. Moreover, because we own what we believe to be one of society's best service institutions and much the better of Buffalo's two major newspapers, we still hope and expect that the News in due course will earn annual profits consistent with its value to Buffalo and appropriate to our level of investment. Our policy remains to improve and hold the News and not to sell it.

The News remains a salable property, even with its current troubles, so long as its share of circulation and advertising is stable-to-inching-ahead, and we could easily improve our consolidated operating earnings and the percentage return we earn on our shareholders' investment by selling the News and reinvesting the proceeds, after tax effects, in profit-earning

assets. That we are not even slightly tempted to do so demonstrates our conviction that the proper course is to stay with the News until it either expires, or, much more likely, becomes a solid earner and employer.

Despite our confidence in the probable long-term success of the News, a certain caution is probably appropriate based on the record to date and the nature of the situation. We therefore repeat to our shareholders our warning in previous years regarding what we now believe are unlikely contingencies: "If the litigation continues and if the competing paper succeeds in somehow changing the law as enunciated by the Federal Court of Appeals and in obtaining the kinds of injunctions it is seeking, or if any extended strike shuts down the Buffalo Evening News, it will probably be forced to cease operations and liquidate, at an after-tax cost which could exceed $10 million."

PROMOTIONAL SERVICES BUSINESS AND MISCELLANEOUS SOURCES OF OPERATING INCOME

The final components of our consolidated net operating income last year were provided by (1) operating earnings from our promotional services (mainly trading stamp and motivation) business, after deduction of interest and other general parent company expense, plus (2) our share of operating earnings, after deduction of interest and other Wesco general corporate expense, from securities and real estate held by Wesco outside the savings and loan and steel service activities of its subsidiaries.

The promotional services business operated at a sharply increased operating profit, after parent company interest and other general expense and taxes, last year, up to $4,293,000 from $1,932,000 after (properly) giving it credit for the entire income (dividends and interest, plus income tax benefits caused by dividends) from investment of the funds available through "float" caused by trading stamps issued but not yet redeemed. Our shareholders should not be much impressed by most of the increase in operating profit, which was attributable primarily to revisions in our estimates of our liability to redeem outstanding trading stamps. The revisions, which by their nature will not frequently recur, increased 1980 operating income by $1,747,000. However, operating income was also increased by $721,000 through changing our motivation business from a loss to a profit position, a condition we hope will recur indefinitely.

Trading stamp service revenues increased by a minor amount to $16,672,000 last year compared with $15,967,000 in the previous year. Motivation business revenues increased to $2,771,000 from $2,310,000.

In our trading stamp business our "float" — resulting from past issuance of trading stamps when volume was many times greater than the current level — is large in relation to current issuances. (Trading stamp revenues peaked at $124,180,000 in fiscal 1970, and our 1980 revenues of $16,672,000 therefore represented a decline of 87% from peak volume). Eventually, unless stamp issuances improve, earnings from investing "float" will decline greatly. The decline in "float" in recent years, however, has proceeded at an extremely slow rate, and our "float" was $64,053,000 at yearend 1980.

As discussed extensively in previous annual reports (particularly for fiscal 1976), which we urge shareholders to review, accounting for trading stamp redemption liability (which involves estimating the number of stamps that will ultimately be redeemed and the cost per stamp) is a difficult process under any circumstances, but particularly so in an inflationary economy and when stamp issuances decline by a large percentage. We periodically revise our estimated future redemption liability as conditions warrant. In 1980 we made revisions increasing operating income as above described, as explained in detail in Note 2 to our accompanying financial statements.

We intend to remain in the trading stamp business. Many of our present customers, aided by our stamp service, operate unusually successful supermarkets, bowling alleys and other businesses, and we believe that, given the opportunity, we can also provide very useful service to new customers.

One final item augments our consolidated net operating income. Our share of operating earnings, after deduction of interest and other Wesco general corporate expense, from securities and real estate held by Wesco outside the savings and loan and steel service activities of its subsidiaries, amounted to $695,000 in 1980, compared with $492,000 in the previous year.

NET GAINS ON SALES OF CORPORATE SECURITIES AND IMPORTANT FIXED ASSETS

In our total assets, located among our five operating businesses, we hold considerably more corporate securities than might be expected in a consolidated enterprise of our size at the close of 1980, as we report consolidated revenues of $219 million and consolidated net worth of $146 million (see Note 3 to our accompanying consolidated financial statements).

Most of these holdings of corporate securities are held because of the very nature of the particular business in which they are owned. For instance, the trading stamp business owns liquid assets to provide for ultimate redemption of stamps, and the savings and loan business holds liquid assets to provide for repayment of savings account holders. The remaining security holdings exist temporarily, primarily in Wesco Financial Corporation, pending their disposition to provide funds for use in buying additional businesses.

Only Mutual Savings, which is barred by law from owning most common stocks, has significant holdings of preferred stocks. Most holdings, therefore, are of common stocks. Our reported operating earnings include only the dividends from our stockholdings, after taxes. And, because the corporations whose common stock we own also have and reinvest earnings not paid out as dividends, a process which ultimately raises market value of the stock we own, we also realize irregularly net capital gains from sales of portions of our holdings.

In addition, our various businesses occasionally sell important buildings, machinery or other fixed assets, as such businesses adjust to changing conditions. In 1980 the sale of branch office facilities by Mutual Savings fell into this category.

In 1980 our share of the gain from sale of Mutual Savings' branch office facilities was $2,332,000, and our total share of the net gains from sale of corporate securities was $1,493,000. Our aggregate share of both types of capital gains combined was $3,825,000, compared with $1,214,000 in the previous year.

PINKERTON'S, INC.

At yearend 1980 we owned non-voting stock representing 35% of the equity in Pinkerton's, Inc., the leading national security and investigation service company.

Our ownership of this non-voting interest demonstrates that, when all factors are considered, we often would rather buy stock we can't or won't vote than absolute control. We think the rationality of use-of-capital decisions is improved when the repertoire of a corporate manager includes purchases of business interests which do not augment the number of people to whom the manager can give orders. However, we have generally observed a low interest among corporate managers.in passive investments, even when available at much better price/earnings and price/book value ratios than controlling positions. The strong preference for controlling positions is ordinarily justified by (1) expected improvements from a change in control based on a high appraisal of the business skills of the managers of the corporate investor compared to the managers of the corporate investee and (2) a low appraisal of the likelihood that the managers of the corporate investee, if free to act independently, will make decisions which best serve the interests of ultimate shareholders. Our view is different, and, although we expect always to concentrate our activities primarily in operating businesses, we also have an uncommon interest in passive positions for the following reasons:

1. We know that our business skills are frequently inferior by a wide margin to those of others, as we can prove from comparative figures and our audited record reflecting gross errors;
2. We believe that many corporate managers can be trusted to serve the shareholders' interests even when the shareholders have no practical power to control or replace management;
3. We think the advantage of buying at a non-premium price, because control is absent, often counterbalances the disadvantage, if any, from lack of control;
4. Our consolidated enterprise includes operating businesses required by their nature to own significant passive investments.

We hope to become better known for our uncommon willingness to own "non-voting-partnership" interests in businesses and to attract other offerings like that which produced our Pinkerton's holding. And we are sure, based on five years' observation from our non-voting position, that Pinkerton's wouldn't have been managed one whit better or one whit more in its shareholders' interests if we had purchased voting control.

Our total investment in Pinkerton's at cost was $23,364,000 which, with respect to the major portion thereof constituting

marketable securities, is substantially below current market value. See Note 3 to our accompanying financial statements. Only the dividends we receive from Pinkerton's are included in our reported income. These dividends have increased regularly in recent years, creating part of the income reported above under the heading: "Promotional Services Business and Miscellaneous Sources of Operating Income." The part created by Pinkerton's dividends was $1,429,000 in 1980 and $1,201,000 in 1979.

CONSOLIDATED BALANCE SHEET AND OTHER DATA

Our consolidated balance sheet retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others. As explained in Note 3 to the accompanying financial statements, the aggregate market value of our marketable securities was higher than their aggregate cost at December 27, 1980. We remain in a prudent position when total debt is compared to total net worth and total liquid assets.

Retaining the impeccable bank credit facilitated by a prudent balance sheet position is very important to us. When combined with our practice of doing a certain amount of long-term borrowing in advance of specific need, it gives us maximum financial flexibility to face both hazards and opportunities.

Sections entitled "Principal Business Activities," "Selected Financial Data" and "Management's Discussion and Analysis" are presented beginning on page 13. We invite your careful attention to these items and to our audited financial statements.

A LOOK BACK AND A LOOK AHEAD

We began the 1970s with a single business, trading stamps, which was destined to decline to a small fraction of its former size, and a portfolio of securities, offsetting stamp redemption liabilities, which had been selected by previous owners and would have led to a disastrous result if held through to the present time. (The portfolio, for instance, contained a substantial amount of very-long-term, low-coupon municipal bonds of issuers with declining credit ratings.)

We began the 1980s with five constituent businesses instead of one. In order of acquisition they are: (1) trading stamps and other promotional services, (2) See’s Candy Shops, Incorporated , (3) Mutual Savings, (4) Buffalo Evening News, and (5) Precision Steel.

Our five constituent businesses have more in common than might be noted by a casual observer:

1. They are all high-grade operations, manned by high-grade people operating within a long tradition emphasizing reliable and effective service, and
2. When functioning properly each business will usually generate substantial amounts of cash not claimed by compulsory reinvestment in the same business and therefore available for purchases of new businesses or debt repayment.

The second of these two common characteristics needs additional explanation. Many businesses, once good investments when inflation was low, are now, under inflationary conditions, unable to produce much, if any, cash even when physical volume is constant. Any such business, always cash-starved even while reporting apparently satisfactory profits, is not a candidate, absent some special factor, to become a new subsidiary of ours.

Our balance sheet net worth at February 27, 1971 was about $43 million. By the end of 1980 our balance sheet net worth had increased to approximately $146 million, up 240% in ten years. At February 27, 1971 our equity in aggregate securities was worth about $5 million less than balance sheet cost. At the end of 1980 our equity was worth about $25.6 million more than balance sheet cost. Our average annual total percentage return earned on shareholders investment over the ten years ending December 27, 1980 was approximately 15% per annum, without counting the favorable swing from unrealized loss to unrealized profit in our equity in marketable securities. The percentage return earned was acceptable in a moderate-inflation environment, considering the headwinds in our initial trading stamp business.

In 1980, the year just ended, our total percentage return on the beginning investment of our shareholders was approximately 16%. This percentage return fluctuates from year to year, depending upon various factors including changes in amounts of capital gains realized. The percentage return figure for any one year is not very significant, although the average figure over a period of years, and the trend in such average figure, are of vital importance.

We hope to earn a higher average (though fluctuating) annual total percentage return on shareholders' investment in the future than we have in the past. Our total percentage return on shareholders' investment is now depressed by our substantial commitment to the Buffalo Evening News, producing losses instead of profits. We are trying to correct this condition. Moreover, we expect from time to time to acquire additional businesses which will produce higher returns than the assets disposed of to fund their purchase.

However, even if we succeed in increasing our average annual total percentage return on shareholders' investment (no sure thing), our performance as a company may not do very much for our shareholders as investors if inflation continues at the present rate. As we stated last year , “A 16% return on equity obviously won't do much in real terms for shareholders if the inflation rate is 16%, or even 11% when we also allow for income taxes imposed on owners who must report taxable ‘profits’ while only maintaining their position on the purchasing-power treadmill.”

Inflation is a very effective form of indirect taxation on capital represented by holdings of common stock. We know of no adequate countermeasure, generally available to corporate managers who wish to protect shareholders, to this form of indirect taxation. But, even so, we think a habit of always thinking about shareholders’ interests in real terms, instead of rationalizing growth of managed assets regardless of real effects on shareholders, is quite useful and may fairly be expected of corporate managements. We make a very conscious effort, perhaps with occasional inadvertent lapses, to have and reinforce this habit.

For one example, low stock prices, caused by inflation, together with our preoccupation with real shareholder interests, have intensified our resistance to most proposals that we issue new common stock. We haven't issued a new share, for any reason, for a long time. With rare exceptions American corporations now cannot get as much intrinsic value as they give when new common stock is issued. Our corporation is no exception. And, quite clearly, a corporation can't further its own shareholders' long-term interests by diluting, through new stock issuances, the value underlying each outstanding share. Our unwillingness to accept any such dilution explains our long-unchanged common stock capitalization.

We believe that our (1) heavy emphasis on the cash-generating characteristics of businesses, (2) reluctance to issue new stock and (3) strong balance sheet position are all likely to enjoy increased recognition in future years as qualities to be emphasized by selectors of common stocks for investment.

Cordially yours,

Charles T. Munger, Chairman of the Board
Donald A. Koeppel, President

February 25, 1981

To Our Stockholders

Consolidated operating income (i.e., before all net gains from sales of securities, mortgages and important fixed assets) for the calendar year 1981 increased to $20,895,000 ($4.03 per share) from $16,564,000 ($3.20 per share) in the previous year.

Consolidated net income (i.e., after net gains from sale of securities, mortgages and important fixed assets) increased to $27,626,000 ($5.33 per share) from $20,389,000 ($3.94 per share) in the previous year.

We have four major subsidiaries, See's Candy Shops, Incorporated (100%-owned), Mutual Savings (80%-owned), Precision Steel (80%-owned), and Buffalo Evening News, Inc. (100%-owned), in addition to the basic business (primarily trading stamps) operated by the parent company. Our consolidated income for our two reporting years just ended breaks down as follows (in 000s except for per-share amounts):

Net operating income (loss) of

Year ended about	See's*1	Mutual Savings*2	Steel Business	Buffalo Evening News*3	All other net income*4	Net gains on sales of securities & fixed assets*5	Blue Chip consolidated net income
December 31, 1981	$10,647	$3,393	$1,560	$(531)	$5,826	$6,731	$27,626
Per Blue Chip share	2.06	.65	.30	(.10)	1.12	1.30	5.33
December 31, 1980	$7,270	$4,181	$1,205	$(1,472)	$5,380	$3,825	$20,389
Per Blue Chip share	1.40	.81	.23	(.28)	1.04	.74	3.94

- 1) After reducing income by amortization of intangibles arising from purchase of See's at a large premium over its book value.
- 2) After increasing income by amortization of the discount from Mutual Savings' book value at which the interest was acquired and eliminating gains and losses from sale by Mutual Savings of securities, mortgages and important fixed assets.
- 3) After reducing income by amortization of relatively minor intangibles arising at acquisition of the newspaper.
- 4) After deduction of interest and other corporate expenses. In each year there was an operating loss from promotional services activities before residual consolidated net income was credited with (i) dividends and interest resulting primarily from investment of the funds available through "float" caused by trading stamps issued but not yet redeemed, plus (ii) income tax benefit caused by 85% exclusion of dividends in computing federal income taxes, plus (iii) Blue Chip's share of dividends, interest and rent from securities and real estate held by the Wesco Financial Corporation group outside its savings and loan and steel service activities, plus (iv) in 1980 a net adjustment of Blue Chip's stamp liability account in the amount of $1,747 or $.34 per Blue Chip share, net of taxes, as explained below under "Promotional Services Business and Miscellaneous Sources of Operating Income."
- 5) The 1980 figures comprise $2,332 or $.45 per Blue Chip share attributable to Mutual Savings' sale of 15 branch offices, as explained below under "Mutual Savings and Loan Association," and $1,493 or $.29 per Blue Chip share of net securities gains realized by the various entities including Mutual Savings, net of taxes and minority interest. The 1981 figures relate solely to such net securities gains.

The foregoing breakdown (of the same aggregate earnings) differs somewhat from that used in our audited financial statements. We take the pains to prepare our unconventional breakdown of earnings and to furnish it in this letter because we believe it better explains what is really happening than does our accompanying consolidated income statement in conventional form. Generally, we are trying to improve our annual letter to shareholders each year so as better to disclose the things we would want to be told if the roles were reversed and we were passive investors. However,

we make no effort to provide fresh or novel descriptions. Repetition seems appropriate to us where facts remain both true and analytically important over many years and where certain ideas are part of our fixed business catechism. Accordingly, where previously used words, sentences or paragraphs appear adequate we simply repeat them, inserting up-to-date numbers.

SEE'S CANDY SHOPS, INCORPORATED

The earnings of our 100%-owned subsidiary, See's Candy Shops, Incorporated, increased 43.7% last year, a phenomenal performance considering the general state of retailing in the current recession. We have now owned See's for exactly ten years. Comparative figures for See's for the entire ten-year period of our ownership are set forth below:

Year ended about	Sales	Profits after taxes*	Number of pounds of candy sold	Number of stores open at year end
December 31, 1981	$112,578,000	$11,130,000	24,052,000	199
December 31, 1980	97,715,000	7,747,000	24,065,000	191
December 31, 1979	87,314,000	6,473,000	23,985,000	188
December 31, 1978	73,653,000	6,289,000	22,407,000	182
December 31, 1977	62,886,000	6,262,000	20,921,000	179
December 31, 1976	56,333,000	5,618,000	20,553,000	173
December 31, 1975	50,492,000	5,308,000	19,134,000	172
December 31, 1974	41,248,000	3,229,000	17,883,000	170
December 31, 1973	35,050,000	2,069,000	17,813,000	169
December 31, 1972	31,337,000	2,332,000	16,954,000	167

- These earnings figures are a little higher than Blue Chip Stamps' share of See's earnings shown in the table on page 1 because Blue Chip's share reflects (i) amortization of intangibles arising from purchase of See's stock at a large premium over book value and (ii) state income taxes on See's dividends received by Blue Chip.

See's aggregate sales in pounds held up well last year, being essentially unchanged from the previous year even though prices were increased at a rate which turned out to be somewhat higher than the inflation rate. Shop sales increased, but only because of the impact of additional stores. Shops operating throughout both years registered an aggregate decrease in poundage of 1.6%. Christmas season quantity order sales to businesses declined for the first time since the 1974 recession. Ingredient costs in 1981 increased only moderately and, with revenues up about 15%, See's profits rose sharply to an all-time record.

See's is by far the finest business we have ever purchased, exceeding our expectations, which were quite conservative. Our record as foretellers of the future is often poor, even with respect to businesses we have owned for many years, and we so greatly underestimated See's future that we were lucky to acquire it at all.

However, we have at least had the good sense all these last ten years to want See's chief executive, Chuck Huggins, who has spent his working life in its business, to run the company in his and its traditional way. Chuck Huggins is a splendid man and a splendid manager. It is no minor privilege to be associated with him and the kind of quality enterprise he and his predecessors and co-workers have created.

Boxed chocolate consumption per capita in the United States continues to be essentially static, and the candy-store

business remains subject to extraordinary cost pressures, offset to some extent in 1981 by subnormal increases in ingredient costs. When See's increases prices each year to reflect cost pressures, it never knows whether consumer resistance will cause net profits to fall instead of rise. Thus far, consumers have been willing to keep buying in the amounts required to keep See's profits rising irregularly at an average rate which, aided by large recent gains, has turned out to be quite satisfactory. This state of affairs logically cannot continue forever if, on average, See's costs keep increasing faster than the general rate of inflation. Moreover, in some future years commodity and ingredient prices will rise sharply and unexpectedly, causing unanticipated decreases in profits.

Perhaps because price increases deter purchases for personal consumption more than purchases for gifts, See's seasonal sales peak becomes more extreme each year, causing many operating problems and a growing concentration of See's net income in the single month of December.

See's success to date becomes even more remarkable when its industry background is examined in more detail. So far as we know the candy-store business continues to be terrible to mediocre for all other companies, which tend to suffer from a combination of (1) low sales per square foot of retailing space plus (2) the great seasonality of the business which requires staffing and maintenance of stores at minimum levels grossly unjustified by sales during about 90% of each year.

We believe that See's exceptional profits occur, despite all the problems, mainly because both new and old customers prefer the taste and texture of See's candy, as well as the extremely high level of retailing service which characterizes its distribution. This customer enthusiasm is caused by a virtually fanatic insistence on expensive natural candy ingredients plus expensive manufacturing and distributing methods that ensure rigorous quality control and cheerful retail service. These qualities are rewarded by extraordinary sales per square foot in the stores, frequently two to three times those of competitors, and by a strong preference by gift recipients for See's chocolates, even when measured against much more expensive brands.

At the end of 1981, the portion of Blue Chip's consolidated net worth represented by its interest in See's amounted to $38.3 million and included liquid assets adequate to finance See's substantial annual build-up of pre-Christmas inventories. Obviously, based on See's 1981 earnings of $11.1 million, this investment in See's is worth considerably more than its carrying value in Blue Chip's consolidated balance sheet.

Last year we made "a guarded forecast that See's earnings would increase at least moderately in 1981." In 1982 See's will try again to increase earnings and a modest increase is quite conceivable.

MUTUAL SAVINGS AND LOAN ASSOCIATION

Our equity in Mutual Savings' operating income declined sharply in 1981 to $3,393,000 from $4,181,000 in the previous year.

Earning these reduced profits was an achievement of some note, because in 1981 almost all other savings and loan associations suffered large operating losses and some failed and were absorbed by stronger companies under pressure from governmental regulatory authorities. The financial pressure has continued into 1982. The troubles are caused by a borrowed-short, lent-long position, combined with high current interest rates associated with past and anticipated inflation and removal of much former regulation limiting rate competition for savings accounts. Associations have been forced to pay interest rates to hold savings accounts which are higher than can be covered by locked-in yields from long-term, fixed-rate mortgages acquired years ago in what now seems like a different world.

The sorry state of the savings and loan industry is one more example of the operation of Garrett Hardin's principle for soft sciences (like business, politics, economics and law) that bad ideas are born good. A well-intentioned idea of some kind works fine for a while, then stops working and goes into reverse, as did the basic savings and loan idea of borrowing short and lending long to an extreme degree while depending on governmental regulation to force savers to take an inadequate return in an inflationary period. If, as seems likely, Hardin's principle is part of an inevitable human legacy, tragedy can be averted, partially, only by reversing course when the danger flags start flying as the cherished ideas of the past are faithfully followed. Unfortunately, another perverse phenomenon interferes here — the tendency of the mind to reject the message from a danger signal which is inconsistent with a cherished idea.

At Mutual Savings we were too blind for too long, exactly as Hardin would have predicted, but like the rest of the savings

and loan industry we started coping better with reality when it stopped waving the danger flags at us and started using them to poke us in the head and stomach.

The eventual result of our efforts to cope with reality has been that Mutual Savings has continued to make modest profits despite having a substantial borrowed-short, lent-long position, including a fixed-rate mortgage portfolio bearing what is probably the very lowest average interest rate among all U.S. associations (7.6% per annum at the end of 1981). The 1981 profits occurred, notwithstanding this handicap, because Mutual Savings has had:

1. so far as we know, a higher ratio of shareholders' equity to total interest-bearing liabilities than any other mature U.S. association;
2. a higher-than-normal proportion of assets in short-term, interest-bearing cash equivalents; and
3. a far-higher-than-normal proportion of assets in intermediate-term, tax-exempt bonds and utility preferred stocks producing a tax-equivalent yield of about double that prevailing on the mortgage portfolio of the typical association.

Mutual Savings' balance sheet at the end of 1981 is set forth in summary form in Note 1 to our accompanying financial statements.

Mutual Savings' unusual asset-liability structure was caused in part by the sale in 1980 of all its branch offices, one incident of which was retention of only the lowest-yielding mortgages, albeit those with the shortest remaining terms, In selling all branch offices in 1980 the institution shortened sail to allow for hurricane conditions, not because a hurricane was clearly foreseen, but because of the effect that being poked with danger flags had on our generally cautious nature. A hurricane came in 1981, the end of which is yet to be seen. There is, of course, a price to be paid when caution purchases safety. If interest rates decline sharply and more or less permanently, Mutual Savings will have greatly penalized future earnings through sale of its branch offices.

Moreover, what Mutual Savings has left is no jewel of a business. As it keeps its books it had $48.5 million in shareholders' equity at the end of 1980, on which its operating income was only $3.5 million in 1981, or at the inadequate rate of 7.2% per annum. However, as Blue Chip reports earnings from its equity in this less-than-mediocre business, the results are somewhat better because Blue Chip's equity was originally purchased at a large discount from its book value on the books of Mutual Savings. At the end of 1980 Blue Chip's equity in Mutual Savings was carried in Blue Chip's consolidated balance sheet, net of minority interest, at $19.4 million, and this equity contributed $3.4 million to Blue Chip's consolidated earnings in 1981, or at the rate of 17.5% per annum, including $.6 million of amortization into income, at the rate of 1/40th per year, of the discount from book value at which the equity originally was purchased.

Some additional perspective on the current situation may be obtained by examining the following table:

Calendar year	Blue Chip's average equity in Mutual Savings as carried in Blue Chip's consolidated balance sheet	Blue Chip's share of the cash dividend paid by Mutual Savings during the year	Annual percentage return on Blue Chip's equity from the Mutual Savings dividend
1975	$11,975,000	$1,932,000	16.1%
1976	20,570,000	3,226,000	15.7
1977	23,928,000	3,845,000	16.1
1978	25,285,000	5,287,000	20.9
1979	25,630,000	6,728,000	26.3
1980	22,381,000	9,852,000	44.0
1981	18,778,000	1,922,000	10.2

In 1982 for sure, and perhaps in 1983, Mutual Savings will realize reportable, tax-deductible losses by making sales and reinvestments involving mortgages which will have the effects of bringing the market value of its assets closer to their book value and causing recognition for accounting and income-tax purposes of a portion of the real economic deterioration already in place, caused by interest rates at current levels. Such sales and reinvestments will almost surely cause suspension of dividends from Mutual Savings to its parent corporation, Wesco, in 1982, ending for at least a year or two the important cash flow shown in the immediately preceding table. However, the income and cash-flow effects of a portfolio restructuring at Mutual Savings, after partially offsetting favorable income-tax effects, could quite conceivably

increase in a very material way the dividends Mutual Savings will be able to pay at a later time, perhaps as early as 1984. All restructuring decisions will be made with a view to long-term benefit, ignoring considerations of image.

But, no matter what is done, it looks to us as if operating a savings and loan association in the future is going to present a challenge which, so far, we haven't fully figured out how to meet. We do have a lot of options, including expansion by acquisition, with or without additional investment in Mutual Savings, and we are trying to keep all options open as we ride out the storm.

We do not have any intention to sell Mutual Savings. We hope that it will ultimately find a way to earn higher profits, sufficient at least to permit payment of dividends causing realization of a satisfactory rate of return on the carrying value of Blue Chip's equity.

No savings and loan executive has had an easy time in the last few years. Louis Vincenti, chief executive of both Mutual Savings and Wesco, is no exception. In our view the record he has created is better than those of his peers, reflecting both unusual talent and a very high sense of stewardship for savers and shareholders.

PRECISION STEEL WAREHOUSE, INC.

Our 80%-owned Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, was acquired for approximately $15 million on February 28, 1979. It owns a long-established steel service center business and a subsidiary engaged in the manufacture and distribution of tool room supplies and other products sold under its own brand names. Precision Steel's operating businesses contributed $1,560,000 to our consolidated net income in 1981 compared with $1,205,000 in 1980.The increase in earnings was more than proportionately attributable to operations in the first three quarters of 1981. In the last quarter of 1981 and the first quarter of 1982, earnings have declined substantially, reflecting severe recessionary conditions in the steel industry.

Even under recessionary conditions operations remain profitable, and we anticipate no great change in earnings for the full year 1982.

The minimum shareholders' equity, at Blue Chip's carrying value, required to operate Precision Steel's business at its 1981 level is about $14 million, on which the business earned $1.9 million in 1981 or at a rate of 13.6% per annum.

We knew when we purchased Precision Steel that earning a return, satisfactory under inflationary conditions, on the unleveraged equity capital required to operate its business would be difficult, and we supplied some leverage by borrowing the purchase price, refinancing at a fixed rate as soon as practicable. We ordinarily have reservations concerning financial leverage but are willing, as in this case, to borrow money to purchase as part of our mix of businesses a clean and moderately profitable company like Precision Steel where inventories carried on the LIFO basis represent a substantial part of total assets and where reported earnings are expected usually to turn up in cash, absent optional expansion.

Both Mutual Savings and Precision Steel are owned by Blue Chip Stamps through 80% control of Wesco Financial Corporation, a public company with shares traded on the American Stock Exchange. For more complete information, we encourage Blue Chip shareholders to obtain a copy of Wesco's 1981 annual report.

Simply make your request to:
Wesco Financial Corporation
315 East Colorado Boulevard
Pasadena, California 91109
Attention: Mrs. Jeanne Leach, Treasurer

BUFFALO EVENING NEWS, INC.

Our 100%-owned subsidiary, Buffalo Evening News, Inc., was acquired in April 1977 for approximately $34 million. It now constitutes only approximately $28.5 million of our consolidated net worth, as a result of about $5.5 million of aggregate after-tax operating losses after acquisition. This translates roughly into $11 million of aggregate operating losses before taxes.

However, the operating loss, before taxes, of the News in 1981 was lower than that of 1980, having declined to

$1,091,000 from $2,805,000 in the previous year, which in turn had declined from $4,617,000 in 1979.

The steady reduction in operating loss has been made possible by a combination of aggressive price increases, intense efforts at general cost containment, and reduction or elimination of expenses or losses in three specific categories: (1) litigation expense, (2) expense of "buy-outs" from labor contract provisions made in order to allow the News to benefit from equipment modernization, and (3) the strike losses of 1980. A lot of effort has gone into reducing the overall operating loss — except that more "buy-outs" would have been preferred — and the 1981 results reflect some success.

We predicted accurately the financial improvement in 1980 and 1981. For 1982 we confidently predict a lack of improvement. We anticipate terrible market conditions for the News in 1982.

Buffalo has been hit harder than the average U.S. city by the current recession, and the attrition rate among retailers is sharply and permanently reducing the demand for the advertising service provided by the two main newspapers. In 1981 the News and the Buffalo Courier-Express, the News' main competitor, ran 4,000,000 lines of advertising (10% of their aggregate retail advertising linage) from retailers which by the end of 1982 either will not be in business at all or will be in business as mere remnants of their former selves. Although the Courier-Express is bearing a share of the retailing contraction, that will not stem the losses faced by the News.

It is particularly discouraging that continuing operating losses occur despite aggressive circulation and advertising price increases in the recent past. The News, for instance, increased circulation revenues by 15.2% in 1981, a figure exceeding that achieved in many cities less affected by the recession, helping cause a small but painful reduction in weekday subscribers, and will be forced to be conservative when it again increases circulation prices later in 1982. Based on the News' experience to date, it does not dare go faster in raising circulation prices. And, with a retailing contraction now in progress, the outlook for any above-normal increases in advertising prices also appears very dim. Greater, not smaller, operating losses for the News almost surely lie immediately ahead.

Not all of the difficulties come from purely regional trends. Since publication of our 1980 annual report there have also been a number of adverse developments in newspaper economics not limited to areas like Buffalo which are bearing more than their share of the current recession. Certain important print advertisers, once thought certain to rely almost 100% on newspapers, are experimenting with alternate forms of delivery. As the world has changed, the Washington Star, once by far the strongest daily newspaper in what remains a prosperous and growing Washington, D.C. metropolitan area, has ceased publication, as has the Philadelphia Bulletin, which once occupied a position of seemingly impregnable dominance in its city. The Bulletin was late in starting a Sunday edition, never caught up on Sunday, and eventually lost its weekday advantage as well, cascading to extinction. The ranking of the News among the nation's evening newspapers has been moving steadily upward, not because its circulation is growing but because large evening newspapers are disappearing.

In many of America's remaining two-or-more-metropolitan-newspaper cities, one or two of the newspapers have been reported to be losing money, including but by no means limited to the Boston Herald American, the Los Angeles Herald Examiner, the New York Post, the New York Daily News, the Seattle Post Intelligencer, the Trenton Times, the Cleveland Press, the Detroit Evening News and the Detroit Free Press. In fact, we know of only five metropolitan areas (above 250,000) in the U.S. where two separately owned and economically competing daily newspapers are both now profitable — Houston, Dallas, Denver, San Antonio and Chicago. Houston and Dallas are booming sunbelt cities aided by the OPEC energy cartel, and we suspect that profits in the weaker papers in Denver, San Antonio and Chicago are marginal.

Even more ominous, operating trends have been poor in a number of two-daily newspaper cities, more prosperous than Buffalo, where both newspapers have the same owner. That operating trends can be poor even under such conditions tends to confirm that more aggressive pricing by the News and its main competitor in Buffalo — which might appear akin to the solution hoped for by airlines when they anticipate the end of price wars — is not likely to cause termination of the operating miseries of the News. Pricing in Buffalo, with some limited exceptions, is already quite aggressive, all factors considered. The economic demand for both reading material and advertising service is price-sensitive, and does not necessarily increase, or even remain static, when prices are increased only as much as necessary to cover inexorable increases in the energy-intensive and people-intensive operating costs of our newspaper. Economic forces are at work which are plainly beyond anyone s control, and we are catching at least our share of a widespread malaise. We know of no easy solution.

It is, of course, a temptation when writing an annual letter to shareholders to gloss over difficulties, like those in Buffalo,

and comment extensively concerning successes. We recommend exactly the opposite emphasis to business managers who report to us, and we believe in practicing what we preach. Accordingly, year after year, we re-tell and extend the history of the News, creating the largest single section of our annual letter. This year we surpass all previous records.

The News had no Sunday edition when acquired. The principal competitor, the Buffalo Courier-Express, published without opposition on Sundays. As we explained in detail in our 1977 through 1980 annual reports, the long-term survival of the News clearly required that it inaugurate a Sunday edition. [Of that there was simply no question. Real trouble has been the invariable eventual outcome for every other daily newspaper in the United States, no matter how extreme its past record of prosperity and popularity, which relied overlong, in an important city, exclusively on weekday publication while a significant seven-day competitor enjoyed a Sunday monopoly. In fact, only three other "no-Sunday" papers, competing against such "with-Sunday" papers in important cities, survived as late as 1977, even though many such "no-Sunday" papers once had long histories of profitability derived from dramatic advantages in weekday circulation and advertising over their "with-Sunday" competitors. Moreover, the three other survivors all were in serious trouble in 1977. And since then one of the three survivors, the Cincinnati Post, has been preserved, after incurring huge losses, only through the grace of its competitor's absorbing it into a minority share of a joint operation with approval of the U.S. Attorney General as required by the Federal Newspaper Preservation Act of 1970. A second of these "no-Sunday" survivors of 1977, the Cleveland Press, after also incurring huge losses, was recently sold by its experienced Ohio-based newspaper-chain owner (Scripps-Howard), under distress conditions, to a wealthy Cleveland man who forthwith spent millions of dollars inaugurating a Sunday edition. Even after so recognizing the cause of its difficulties, and despite tying Sunday circulation to a very substantial daily circulation base, the Cleveland Press now appears almost surely doomed to continuing and apparently irreversible operating losses by its reluctance or inability to create a Sunday edition at a timely point in its history. The only other remaining "no-Sunday" survivor is the New York Post, controlled by the able Rupert Murdoch, which has been losing many millions of dollars per year and which has announced it must have a Sunday edition to survive. Prospects for its survival looked virtually nil until 1981 when the New York Post's principal competitor, the New York Daily News, by far the biggest newspaper in New York City, announced it was tired of losing money and was looking for a buyer. If the New York Daily News eventually closes, the New York Post may well survive, aided by the Sunday edition it would then surely have. In any event, one way or another, within a very few years the "no-Sunday" paper, competing in an important American city against a "with-Sunday" competitor, will be as extinct as the dodo bird.]

Under such circumstances, the News commenced publishing Sundays late in 1977, as it plainly had to do if it cared at all about its long-term future. In response, an antitrust lawsuit was filed by the competing paper which for the first time faced the prospect of competition on Sundays as well as weekdays. The lawsuit, in turn, resulted in some interlocutory (i.e., temporary and not final) injunctions which, among other things, created severe disruptions in normal circulation procedures under midwinter conditions and restricted certain business promotion practices of the News, commonplace within the newspaper industry, while similar but more aggressive practices of the competing paper were not prohibited.

These interlocutory injunctions against the News were reversed on appeal in 1979. In its unanimous decision for reversal of the injunctions, the Federal Court of Appeals reasoned that the generally pro-competitive antitrust laws should not be used in an anti-competitive fashion by enjoining normal promotional practices, such as those used by the News, in the course of normal competition such as inauguration of a Sunday edition.

Of course, the elimination of the harmful interlocutory injunctions did not automatically improve the circulation and advertising linage of the News' Sunday edition. Success in the market had to be won slowly, if it could be won at all, through creating a desirable value for customers. Moreover, achieving success was made more difficult by the fact that it was beyond the power of the appellate court to reverse certain material damage suffered by the News as a result of the interlocutory injunctions and accompanying publicity. Damage inflicted on an infant at birth impairs its subsequent life even after the people in charge of the operating room have decided that different delivery procedures would have been appropriate.

Despite the damage at birth, there was a gradual trend toward success. The Sunday edition of the News has been recognized by subscribers for editorial merit and rewarded by steady circulation growth, needed considering the substantial Sunday-circulation lead of its principal competitor. Great credit must be given to Murray Light, Editor of the News, and other editors and reporters, for consistent delivery of a product which deserves and has received increased acceptance by the Greater Buffalo community. The circulation of the News' Sunday edition was over 183,000 copies in February 1982, up from approximately 178,000 copies in February 1981 which, in turn, was up from 173,000 copies in February 1980. We expect Sunday gains to continue. Weekday circulation decreased slightly in 1981, after increases in

both 1980 and 1979, and the weekday News continues to be greatly preferred to the weekday Courier-Express by both readers and advertisers. As this is written we believe that, measured against levels twelve months earlier and ignoring at both papers meaningless temporary fluctuations caused by special promotion, circulation at the Courier-Express is essentially unchanged on both weekdays and Sundays whereas at the News Sunday circulation is up about 3% and weekday circulation is down about 2%. The News' total weekday circulation is still more than twice that of the Courier-Express, and the weekday circulation split in the close-in areas most important to advertisers remains considerably more favorable to the News than the split in total circulation. Moreover, to this point the News has pretty well held its own on weekdays as a strictly afternoon newspaper without following the practice in most other major two-competing-newspaper cities (e.g., in Dallas, Houston, Seattle, Detroit and Denver) where the afternoon newspaper has gone "all-day" by commencing publication of a morning edition for limited distribution by street sales and home delivery in outlying areas.

On Sundays, the Courier-Express continues to have a little less than 60% of the two newspapers' combined circulation.

We do not know precisely the News' share of the combined advertising revenues of the two newspapers, but we believe it was essentially unchanged during the last two years at about 60%, or perhaps a bit higher. Presumably the Courier-Express lost at least as much money as the News last year.

Overall, this situation is not desirable for our employees or shareholders. And labor relations are affected in a none-too-predictable fashion when employers are unable to incur additional costs without bearing unacceptable losses.

Approximately 83% of the News' employees are members of its 13 different labor unions which through bargained settlements over many years have helped create collective bargaining agreements some of which contain provisions, designed to save jobs, which prevent technological change. With occasional exceptions, all in recent years, as each new collective bargaining agreement was negotiated the union involved sought to improve, from its own point of view, on the expiring collective bargaining agreement, with the net effect that (1) the newspaper was often left weaker on account of inefficient operations and (2) there was often some leapfrogging of benefits, giving a particular union more than its proportionate share of aggregate available economic advantage.

By the time Blue Chip Stamps purchased the News in 1977, this process, combined with a similar process at the Courier-Express and the general state of the newspaper business in Buffalo, had greatly reduced profits of both newspapers. In fact, profits were so minimal that unless more rapid technological progress were allowed and the leapfrogging process ended in favor of conservative pattern settlements, one of the two major newspapers eventually would be forced to cease publication, as has happened in response to similar pressures in major city after major city, on both sides of the Atlantic. In recognition of these facts, the Courier-Express in the years immediately preceding 1977 obtained needed union concessions and suffered no strikes.

There were also grounds for optimism concerning labor relations at the News. We believed in 1977 when we purchased the News that the enterprise-destroying pattern of labor relations which had killed so many metropolitan newspapers was unlikely to kill the News in Buffalo. For one thing, the News had an up-from-the-ranks labor-relations executive, Richard Feather, whom we instantly admired and trusted as fair-minded and constructive and perceived as likely to be so regarded by union members at the News. For another, we made a point, before closing the acquisition, of meeting some of the union leaders and their counsel, and they likewise impressed us favorably. Further, we noticed a great professionalism in employees at the News. Production people and reporters alike cared about the quality of their product, causing us to conclude that they would care similarly about the security and continuation of a common enterprise. Still further, we perceived a high level of friendship and communication among employees of the News, across craft-union lines. Indeed, the enterprise is so old and its jobs so well regarded that jobholders of all kinds have for decades urged their relatives and friends to join the News, often in different craft unions, creating as the years went by something more like a family business than might seem possible to anyone not familiar with it. Finally, we had enjoyed constructive relations with diverse and major labor unions elsewhere and did not enter Buffalo with any plan to seek destruction of long-established benefits, although we did hope to use negotiated voluntary "buy-outs" to make some particularly important reductions in future costs. All these factors, together with the News' long history of labor peace, contributed to our willingness to purchase the News, although at least two other prospective buyers, perhaps more fearful of the risks from having an unusually large number of separate unions, had refused to pay the asking price for the paper.

Until 1980 the long no-strike history continued much as we expected, despite economic forces and troubles which frequently caused operating losses for the News and disappointing wage and salary increases for union members and other employees.

However, with 13 different unions and serious external pressures from competition and inflation, labor peace requires that 14 different groups (the News' management plus all 13 unions), without any exception, understand well the common danger, and, even if moving backward in inflation-adjusted economic terms, be wise and considerate of one another at all times. Even in the presence of the unusually favorable conditions for labor peace at the News, such unanimous wisdom and restraint are a lot to expect, given (1) the limitations of human nature, including that on management's side of the table, (2) the tradition, carried over from a different era, at each union that its main preoccupation should be vigorously to enhance and protect the interests of its own members, and (3) the fact that technological changes do not arrive at a steady pace and with effects allocated equally to each union.

The long labor peace ended in December 1980, when one small union group went on strike in an effort to insert new manning requirements, and new requirements of pay for work even if not performed, into its collective bargaining agreement. Most of the other unions' members, recognizing the pattern-breaking nature of the striking union group's demands, ignored a picket line and reported for work, but, finally, most of the News' pressmen refused to continue working, and the News was unable to continue publishing.

The gravity of the strike, its harmful effect on the potentiality for continued existence of the News, can hardly be overstated. An area-wide metropolitan newspaper which is closed down by a strike while a similar competitor continues publishing does not merely lose a lot of money while the strike goes on and then return to publishing at approximately the same annual profit (or loss) as before. Instead, because the competing paper gains circulation rapidly during the strike, the closed-down paper usually suffers such a loss of competitive position that it fairly soon reaches a point where it is unwise to reopen at all. For instance, in Montreal what had long been the overwhelmingly dominant English-language newspaper recently lost many millions of dollars, before its ultimate expiration, in a fruitless and foolish attempt to reopen after a strike of several months during which its main competitor continued to publish.

Such being the facts of life, the News had no practicable alternative, when its strike occurred in 1980, except to prepare to face rationally whatever degree of impaired position resulted from the strike. Clearly, if the strike was an extended one, the sensible decision would be not to renew publication. Nor was the News willing to settle its disagreement with the striking union group in any manner unfair to other unions involved, under conditions of common external hazard, in serial bargaining of union contracts. A resolution of the dispute unfair to unions which had settled earlier would lead to a ruinous resumption of leapfrogging to the ultimate detriment of the News and all its employees, including those attempting to take the first jump.

Fortunately, the amount of good will and good sense at the News was sufficient, as the matter worked out, to cause the strike to end in two days without, in the News' view, unfairness to unions which had settled earlier. However, the strike augmented the News' pre-tax losses by several hundred thousand dollars in 1980 and also caused a small loss of competitive position. Both economic results, of course, diminish the capacity of the News to compensate its employees in the future as well as its prospects for beginning to pull its economic weight for shareholders.

In 1981 there was no major labor crisis at the News although hardships were being shared instead of advances. With a very few exceptions the News' economic difficulties in recent years have come in spite of an overall attitude of understanding in its employees and not on account of a lack of such understanding. The ultimate survival of the News continues to depend not only on its competitive position but also on repetitive success on the part of management and all unions in dealing fairly and wisely with one another, under very difficult conditions, changing habits formed in a different era.

The litigation against the News, filed by former owners of the Courier-Express in 1977 when the News commenced publishing on Sundays, remains pending. However, the litigation has been dormant in 1981, following purchase of the Courier-Express by the Minneapolis Star and Tribune Company, which has a history of preferring the exercise of business and journalistic skills over court battles. On the other hand, possibly as a result of this preference, the Courier-Express is now a more effective competitor than it was under its former owners.

However, the improved Courier-Express is not making headway against the News, which is also improving. And even though we anticipate an unsatisfactory 1982 year, we anticipate better operating results in the more remote future. Because we own what we believe to be one of society's best service institutions and much the better of Buffalo's two major newspapers, we still hope and expect that the News in due course will earn annual profits consistent with its value to Buffalo and appropriate to our level of investment. This generally has been the outcome for the better of two competing seven-day newspapers and despite some new economic variables affecting metropolitan newspapers, we believe that

such outcome is likely for the News.

This is not to say that we will ever really get well, considering all effects of our initial decision to buy the News. Shareholders can easily calculate that the reported losses of the News are a small part of the economic detriment our decision created. While convention doesn't require reporting of "opportunity cost" losses to shareholders, we believe they are just as important as conventional reported losses and should be faced just as squarely. If we hadn't purchased the News in 1977 but had simply earned returns on the unspent purchase price comparable with the average earning power of the rest of our shareholders' equity, we would now have about $70 million in value of other assets, earning over $10 million per year, in place of the Buffalo Evening News and its current red ink. No matter what happens in the future in Buffalo we are about 100% sure to have an economic place lower than we would have occupied if we had not made our purchase. In a period like the present one, where passive returns on capital before inflation are high, an inadequate or negative return persisting for any extended period is almost impossible to make up through later success, after allowing for probable returns from alternative capital uses. When other capital is sprinting, remaining in the starting blocks for a long time prevents one from ever catching the field.

Of course, we can't now relive the past but must simply adopt the correct business strategy for the present situation. That strategy is clearly for the News to keep doing the very best job it can for its city, its employees, its readers and its advertisers, seven days a week, unless and until some combination of our principal competitor's relative strength, our intolerable losses, and our labor-trouble weakness makes the long-term future look hopeless. There is no such situation now and we think it extremely improbable that such a situation will occur in the future. If it ever does, we will face it. But we will first exert every effort to make certain it never occurs, believing as we do that the News has both the product and the acceptance that should make its efforts successful.

The News remains a salable property, even with its current troubles, so long as its share of circulation and advertising is stable-to-inching-ahead, and we could easily improve our consolidated operating earnings and the percentage return we earn on our shareholders' investment by selling the News and reinvesting the proceeds, after tax effects, in profit-earning assets. That we are not even slightly tempted to do so demonstrates our conviction that Buffalo will have a reasonably felicitous future as a city and that the fine people who work at the News will ultimately succeed in making it a sound business for its owners and employees, through continued provision of sound service to its customers. We still plan to stay with the News until it either expires, or, far more likely, becomes a solid earner and employer.

Despite our confidence in the probable long-term success of the News, caution is appropriate based on the record to date and the nature of the situation. We therefore repeat to shareholders our warning in previous years regarding what we now believe are unlikely contingencies: "If the litigation continues and if the competing paper succeeds in somehow changing the law as enunciated by the Federal Court of Appeals and in obtaining the kinds of injunctions it is seeking, or if any extended strike shuts down the Buffalo Evening News, it will probably be forced to cease operations and liquidat, at after tax cost which could exceed $10 million."

PROMOTIONAL SERVICES BUSINESS AND MISCELLANEOUS SOURCES OF OPERATING INCOME

The final components of our consolidated net operating income last year were provided by (1) operating earnings from our promotional services (mainly trading stamp and motivation) business, after deduction of interest and other general parent company expense, plus (2) our share of operating earnings, after deduction of nterest and other Wesco general corporate expense, from securities and real estate held by Wesco outside the savings and loan and steel service activities of its subsidiaries.

The promotional services business operated at a sharply decreased profit, after parent company interest and other general expense and income taxes, last year, down to $3,659,000 from $4,293,000 after (properly) giving it credit for the entire income (dividends and interest, plus income tax benefits caused by dividends) from investment of the funds available through "float" caused by trading stamps issued but not yet redeemed. Our shareholders should not be discouraged by the decrease in after-tax profit, which was attributable to the fact b 8U that favorable revisions in our estimates of our liability to redeem outstanding trading stamps were made in but not in 1981. The revisions, which by their nature will not frequently recur, increased 1980 after-tax profit by $1,747,000, and, therefore, in the absence of such revisions after-tax profit would have improved last year.

Although trading stamp service revenues decreased by only a minor amount to $15,619,000 in 1981 compared with

$16,672,000 in 1980, they are expected to drop materially in 1982. By the time this report is distributed, we understand that the Stater Bros. supermarket chain, which accounted for 51% of our trading stamp revenues in 1981 and which has recently been for sale, will have publicly announced that it will discontinue giving trading stamps on April 1, 1982. Loss of the Stater Bros. account will present us with a serious challenge: We must not only continue our efforts in adding to our customer base (for example, in the retail gasoline trade, where we have recently had considerable success) but also try to replace the lost grocery business by signing up a competing grocery chain, which we have been unable to do in the past because of our commitment to Stater Bros. We are as convinced as ever that trading stamps are an effective point-of-purchase sales promotion device for supermarkets, service stations, bowling alleys and the like. We intend to remain in the trading stamp business.

In our trading stamp business our "float" — resulting from past issuance of trading stamps when volume was many times greater than the current level — is large in relation to current issuances. (Trading stamp revenues peaked at $124,180,000 in fiscal 1970, and our 1981 revenues of $15,619,000 therefore represented a decline of 87% from peak volume.) Eventually, unless stamp issuances improve, earnings from investing "float" will decline greatly. The decline in "float" in recent years, however, has proceeded at an extremely slow rate, and our reserved liability for trading stamp redemption was $64,262,000 at yearend 1981.

As discussed extensively in previous annual reports (particularly for fiscal 1976), which we urge shareholders to review, accounting for trading stamp redemption liability (which involves estimating the number of stamps that will ultimately be redeemed and the cost per stamp) is a difficult process under any circumstances, but particularly so in an inflationary economy and when stamp issuances decline by a large percentage. We periodically revise our estimated future redemption liability as conditions warrant. In 1980 we made revisions increasing operating income as above described, as explained in detail in Note 2 to our accompanying financial statements.

Motivation business revenues decreased to $1,446,000 from $2,771,000, but are expected to rise in 1982.

One final item augments our consolidated net operating income. Our share of operating earnings, after deduction of interest and other Wesco general corporate expense, from securities and real estate held by Wesco outside the savings and loan and steel service activities of its subsidiaries, amounted to $1,665,000 in 1981, compared with $695,000 in the previous year.

NET GAINS ON SALES OF CORPORATE SECURITIES, MORTGAGES AND IMPORTANT FIXED ASSETS

In our total assets, located among our five operating businesses, we hold considerably more corporate securities than might be expected in a consolidated enterprise of our size at the close of 1981, as we report consolidated revenues of $246 million and consolidated net worth of $169 million (see Note 3 to our accompanying consolidated financial statements).

Most of these holdings of corporate securities are held because of the very nature of the particular business in which they are owned. For instance, the trading stamp business owns liquid assets to provide for ultimate redemption of stamps, and the savings and loan business holds liquid assets to provide for repayment of savings account holders. The remaining security holdings exist temporarily, primarily in Wesco Financial Corporation, pending their disposition to provide funds for use in buying additional businesses.

Only Mutual Savings, which is barred by law from owning most common stocks, has significant holdings of preferred stocks. Most holdings, therefore, are of common stocks. Our reported operating earnings include only the dividends from our stockholdings, after taxes. And, because the corporations whose common stock we own also have and reinvest earnings not paid out as dividends, a process which ultimately raises market value of the stock we own, we also realize irregularly net capital gains from sales of portions of our holdings.

In addition, our various businesses occasionally sell important buildings, machinery or other fixed assets, as such businesses adjust to changing conditions. In 1980 the sale of branch office facilities by Mutual Savings fell into this category. No significant sale of fixed assets occurred in 1981.

In 1980 our share of the gain from sale of Mutual Savings' branch office facilities was $2,332,000, and our total share of the net gains from sale of corporate securities was $1,493,000. Our aggregate share of all types of special gains

combined was $3,825,000 in 1980, compared with $6,731,000 in 1981, all from the sale of securities.

PINKERTON'S, INC.

At yearend 1981 we owned non-voting stock representing 37% of the equity in Pinkerton's, Inc., the leading national security and investigation service company.

Our ownership of this non-voting interest demonstrates that, when all factors are considered, we often would rather buy stock we can't or won't vote than absolute control. We think the rationality of use-of-capital decisions is improved when the repertoire of a corporate manager includes purchases of business interests which do not augment the number of people to whom the manager can give orders. However, we have generally observed a low interest among corporate managers in passive investments, even when available at much better price/earnings and price/book value ratios than controlling positions. The strong preference for controlling positions is ordinarily justified by (1) expected improvements from a change in control based on a high appraisal of the business skills of the managers of the corporate investor compared to the managers of the corporate investee and (2) a low appraisal of the likelihood that the managers of the corporate investee, if free to act independently, will make decisions which best serve the interests of ultimate shareholders. Our view is different, and, although we expect always to concentrate our activities primarily in operating businesses, we also have an uncommon interest in passive positions for the following reasons:

1. We know that our business skills are frequently inferior by a wide margin to those of others, as we can prove from comparative figures and our audited record reflecting gross errors;
2. We believe that many corporate managers can be trusted to serve the shareholders' interests even when the shareholders have no practical power to control or replace management;
3. We think the advantage of buying at a non-premium price, because control is absent, often counterbalances the disadvantage, if any, from lack of control;
4. Our consolidated enterprise includes operating businesses required by their nature to own significant passive investments.

We hope to become better known for our uncommon willingness to own "non-voting-partnership" interests in businesses and to attract other offerings like that which produced our Pinkerton's holding. And we are sure, based on five years' observation from our non-voting position, that Pinkerton's wouldn't have been managed one whit better or one whit more in its shareholders' interests if we had purchased voting control.

Our total investment in Pinkerton's at cost was $23,364,000, which, with respect to the major portion thereof constituting marketable securities, is substantially below current market value. See Note 3 to our accompanying financial statements. Only the dividends we receive from Pinkerton's are included in our reported income. These dividends have increased regularly in recent years, creating part of the income reported above under the heading: "Promotional Services Business and Miscellaneous Sources of Operating Income." The part created by Pinkerton's dividends was $1,730,000 in 1981 and $1,429,000 in 1980.

CONSOLIDATED BALANCE SHEET AND OTHER DATA

Our consolidated balance sheet retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others. As explained in Note 3 to the accompanying financial statements, the aggregate market value of our marketable securities was higher than their aggregate cost at December 26, 1981. In addition, an office building and related real estate owned by Wesco Financial Corporation has a market value substantially in excess of carrying value. We remain in a prudent position when total debt is compared to total net worth and total liquid assets.

Retaining the impeccable bank credit facilitated by a prudent balance sheet position is very important to us. When combined with our practice of doing a certain amount of long-term borrowing in advance of specific need, it gives us maximum financial flexibility to face both hazards and opportunities.

Sections entitled "Principal Business Activities," "Selected Financial Data" and "Management's Discussion and Analysis" are presented beginning on page 13. We invite your careful attention to these items and to our audited financial statements.

A LOOK BACK AND A LOOK AHEAD

We began the 1970s with a single business, trading stamps, which was destined to decline to a small fraction of its former size, and a portfolio of securities, offsetting stamp redemption liabilities, which had been selected by previous owners and would have led to a disastrous result if held through to the present time. (The portfolio, for instance, contained a substantial amount of very-long-term, low-coupon municipal bonds of issuers with declining credit ratings.)

We began the 1980s with five constituent businesses instead of one. In order of acquisition they are: (1) trading stamps and other promotional services, (2) See's Candy Shops, Incorporated, (3) Mutual Savings, (4) Buffalo Evening News, and (5) Precision Steel.

Our five constituent businesses have more in common than might be noted by a casual observer:

1. They are all high-grade operations suffused to a considerable extent with the business ideas of Benjamin Franklin, manned by high-grade people operating within a long tradition emphasizing reliable and effective service, and
2. When functioning properly each business will usually generate substantial amounts of cash not claimed by compulsory reinvestment in the same business and therefore available for purchases of new businesses or debt repayment.

The second of these two common characteristics gets more important every year as inflation continues. Many businesses, once good investments when inflation was low, are now, under inflationary conditions, unable to produce much, if any, cash even when physical volume is constant. Any such business, always cash-starved even while reporting apparently satisfactory profits, is not a candidate, absent some special factor, to become a new subsidiary of ours.

Our balance sheet net worth at March 4, 1972 was about $46 million. By the end of 1981 our balance sheet net worth had increased to approximately $169 million, up 267% in ten years, after payment of regular dividends. At March 4, 1972 our equity in aggregate securities was worth about $3 million less than balance sheet cost. At the end of 1981 this equity was worth about $26.7 million more than balance sheet cost. Our average annual total percentage return earned on shareholders' investment over the ten years ending December 26, 1981 was approximately 15% per annum, without counting the favorable swing from unrealized loss to unrealized profit in our equity in marketable securities. The percentage return earned was acceptable in a moderate-inflation environment, considering the headwinds in our initial trading stamp business.

In 1981, the year just ended, our total percentage return on the beginning investment of our shareholders was approximately 19%. This percentage return fluctuates from year to year, depending upon various factors including changes in amounts of capital gains realized. The percentage return figure for any one year is not very significant, although the average figure over a period of years, and the trend in such average figure, are of vital importance.

We hope to earn a higher average (though sharply fluctuating) annual total percentage return on shareholders' investment in the next ten years than we have in the ten years just past. Our total percentage return on shareholders' investment is now depressed by our substantial commitment to the Buffalo Evening News, producing losses instead of profits. We are trying to correct this condition. Moreover, we expect from time to time to acquire additional businesses which eventually will produce higher returns than the assets disposed of to fund their purchase. A better experience in the future is far from a sure thing, but it may well be achieved if future errors, headwinds, and reverses are no worse than the ample number characterizing our past.

However, even if we succeed in increasing our average annual total percentage return on shareholders' investment, our performance as a company may not do very much for our shareholders as investors if inflation continues at the present rate. As we point out year after year, "A 16% return on equity obviously won't do much in real terms for shareholders if the inflation rate is 16%, or even 11% when we also allow for income taxes imposed on owners who must report taxable 'profits' while only maintaining their position on the purchasing-power treadmill."

Inflation is a very effective form of indirect taxation on capital represented by holdings of common stock. We know of no adequate countermeasure, generally available to corporate managers who wish to protect shareholders, to this form of indirect taxation, But, even so, we think a habit of always thinking about shareholders' interests in real terms, instead of rationalizing growth of managed assets regardless of real effects on shareholders, is quite useful and may fairly be expected of corporate managements. We make a very conscious effort, perhaps with occasional inadvertent lapses, to have and reinforce this habit.

For one example, low stock prices, caused by inflation, together with our preoccupation with real shareholder interests,

have intensified our resistance to most proposals that we issue new common stock. We haven't issued a new share, for any reason, for a long time. With rare exceptions American corporations now cannot get as much intrinsic value as they give when new common stock is issued. Our corporation is no exception. And, quite clearly, a corporation can't further its own shareholders' long-term interests by diluting, through new stock issuances, the value underlying each outstanding share. Our unwillingness to accept any such dilution explains our long-unchanged common stock capitalization.

We believe that our (1) heavy emphasis on the cash-generating characteristics of businesses, (2) reluctance to issue new stock and (3) strong balance sheet position are all likely to enjoy increased recognition in future years as qualities to be emphasized by selectors of common stocks for. investment.

Cordially yours,

Charles T. Munger, Chairman of the Board
Donald A. Hoeppel, President

March 18, 1982

To Our Stockholders:

Consolidated operating income (i.e., before all net gains from sales of securities, mortgages and important fixed assets) for the calendar year 1982 increased to $22,241,000 ($4.30 per share) from $20,895,000 ($4.03 per share) in the previous year.

Consolidated net income (i.e., after net gains from sale of securities, mortgages and important fixed assets) increased to $45,342,000 ($8.76 per share) from $27,626,000 ($5.33 per share) in the previous year.

We have four major subsidiaries, See's Candy Shops, Incorporated (100%-owned), Mutual Savings (80%-owned), Precision Steel (80%-owned), and Buffalo Evening News, Inc. (100%-owned), in addition to the basic business (primarily trading stamps) operated by the parent company. Our consolidated income for our two reporting years just ended breaks down as follows fin 000s except for per-share amounts):

Net operating income (loss) of

Year ended about	See's(1)	Mutual Savings(2)	Steel Business	Buffalo Evening News(3)	All other net income(4)	Net gains on sales of securities & fixed assets(5)	Blue Chip consolidated net income
December 31, 1982	$12,217	$3,296	$276	$(598)	$7,050	$23,101	$45,342
Per Blue Chip share	2.36	.64	.05	(.11)	1.36	4.46	8.76
December 31, 1981	$10,647	$3,393	$1,560	$(531)	$5,826	$6,731	$27,626
Per Blue Chip share	2.06	.65	.30	(.10)	1.12	1.30	5.33

1. After reducing income by amortization of intangibles arising from purchase of See's at a large premium over its book value.
2. After increasing income by amortization of the discount from Mutual Savings' book value at which the interest was acquired and eliminating gains and losses from sale by Mutual Savings of securities, mortgages and important fixed assets.
3. After reducing income by amortization of relatively minor intangibles arising at acquisition of the newspaper.
4. After deduction of interest and other corporate expenses. In each year there was an operating loss from promotional services activities before residual consolidated net income was credited with (i) dividends and interest resulting primarily from investment of the funds available through "float" caused by trading stamps issued but not yet redeemed, plus (ii) income tax benefit caused by 85% exclusion of dividends in computing federal income taxes, plus (iii) Blue Chip's share of dividends, interest and rent from securities and real estate held by the Wesco Financial Corporation group outside its savings and loan and steel service activities, plus (iv) in 1982 a net adjustment of Blue Chip's stamp liability account in the amount of $339 or $.07 per Blue Chip share, net of taxes, as explained below under "Promotional Services Business and Miscellaneous Sources of Operating Income."
5. The 1982 figures comprise $(1,943) or $(.38) per Blue Chip share attributable to Mutual Savings' sale of mortgage-backed securities at a loss, as explained below under "Mutual Savings and Loan Association," and $25,044 or $4.84 per Blue Chip share of net securities gains realized by the various entities net of taxes and minority interest. The 1981 figures relate solely to such net securities gains.

The foregoing breakdown (of the same aggregate earnings) differs somewhat from that used in our audited financial statements.

We have taken the pains to prepare our unconventional breakdown of earnings and to furnish it in this letter because we believe it better explains what is really happening than does our accompanying consolidated income statement in conventional form. Generally, we have tried to improve our annual letter to shareholders each year so as better to

disclose the things we would want to be told if the roles were reversed and we were passive investors. However, we have made no effort to provide fresh or novel descriptions. Repetition seems appropriate to us where facts remain both true and analytically important over many years and where certain ideas are part of our fixed business catechism. Accordingly, where previously used words, sentences or paragraphs appear adequate we simply repeat them, inserting up-to-date numbers. We see no more advantage in avoiding repetition in basic information documents like letters to shareholders than, say, in successive editions of a service manual for a slowly-changing engine.

We have no illusion that our type of repetitive annual report, restricted to letters and figures in black and white, represents an optimum. We recognize that the invention of graphs and color pictures improved communication, yet we continue in our own way because it seems adequate in our special case, is cheaper, and is less associated with financial public relations practices we prefer not to emulate.

SEE'S CANDY SHOPS, INCORPORATED

The earnings of our 100%-owned subsidiary, See's Candy Shops, Incorporated, increased 13.8% last year, a respectable performance considering the general state of retailing in the 1981-1982 recession. We have now owned See's for exactly 11 years. Comparative figures for See's for the entire 11-year period of our ownership are set forth below:

Year ended about	Sales	Profits after taxes*	Number of pounds of candy sold	Number of stores open at year end
December 31, 1982	$123,662,000	$12,661,000	24,216,000	202
December 31, 1981	112,578,000	11,130,000	24,052,000	199
December 31, 1980	97,715,000	7,747,000	24,065,000	191
December 31, 1979	87,314,000	6,473,000	23,985,000	188
December 31, 1978	73,653,000	6,289,000	22,407,000	182
December 31, 1977	62,886,000	6,262,000	20,921,000	179
December 31, 1976	56,333,000	5,618,000	20,553,000	173
December 31, 1975	50,492,000	5,308,000	19,134,000	172
December 31, 1974	41,248,000	3,229,000	17,883,000	170
December 31, 1973	35,050,000	2,069,000	17,813,000	169
December 31, 1972	31,337,000	2,332,000	16,954,000	167

- These earnings figures are a little higher than Blue Chip Stamps' share of See's earnings shown in the table on page 1 because Blue Chip's share reflects (i) amortization of intangibles arising from purchase of See's stock at a large premium over book value and (ii) state income taxes on See's dividends received by Blue Chip.

See's aggregate sales in pounds held up well last year, being essentially unchanged from the previous year even though prices were increased at a rate which turned out to be somewhat higher than the inflation rate. Shop sales decreased 1.0% despite the impact of additional stores. Shops operating throughout both years registered a a greater decrease in poundage of 2.3%. Ingredient costs per pound decreased slightly, the first such decrease in years, but other costs increased sharply. The failure to control these other costs so as to more closely match inflation prevented an earnings increase which, considering the favorable trend in ingredient costs, otherwise would have been greater than the 13.8% reported.

See's is by far the finest business we have ever purchased, exceeding our expectations, which were quite conservative. Our record as foretellers of the future is often poor, even with respect to businesses we have owned for many years, and we so greatly underestimated See's future that we were lucky to acquire it at all.

However, we have at least had the good sense all these last eleven years to want See's chief executive, Chuck Huggins, who has spent his working life in its business, to run the company in his and its traditional way. Chuck Huggins is a splendid man and a splendid manager. It is no minor privilege to be associated with him and the kind of quality enterprise he and his predecessors and co-workers have created.

Boxed chocolate consumption per capita in the United States continues to be essentially static, and the candy-store business remains subject to extraordinary cost pressures, offset to some extent in 1981 and 1982 by a subnormal increase followed by a decrease in ingredient costs. When See's increases prices each year to reflect cost pressures, it never knows whether consumer resistance will cause net profits to fall instead of rise. Thus far, consumers have been willing to keep buying in the amounts required to keep See's profits rising irregularly at an average rate which, aided by large recent gains, has turned out to be quite satisfactory. This state of affairs logically cannot continue forever if, on average, See's costs keep increasing faster than the general rate of inflation. Moreover, in some future years commodity and ingredient prices will rise sharply and unexpectedly, causing unanticipated decreases in profits.

Perhaps because price increases deter purchases for personal consumption more than purchases for gifts, See's seasonal sales peak becomes more extreme each year, causing many operating problems and a growing concentration of See's net income in the single month of December.

See's success to date becomes even more remarkable when its industry background is examined in more detail. So far as we know the candy-store business continues to be terrible to mediocre for all other companies, which tend to suffer from a combination of (1) low sales per square foot of retailing space plus (2) the great seasonality of the business which requires staffing and maintenance of stores at minimum levels grossly unjustified by sales during about 90% of each year.

We believe that See's exceptional profits occur, despite all the problems, mainly because both new and old customers prefer the taste and texture of See's candy, as well as the extremely high level of retailing service which characterizes its distribution. This customer enthusiasm is caused by See's virtually fanatic insistence on expensive natural candy ingredients plus expensive manufacturing and distributing methods that ensure rigorous quality control and cheerful retail service. These qualities are rewarded by extraordinary sales per square foot in the stores, frequently two to three times those of competitors, and by a strong preference by gift recipients for See's chocolates, even when measured against much more expensive brands.

At the end of 1982, the portion of Blue Chip's consolidated net worth represented by its interest in See's amounted to $50.5 million and included liquid assets more than adequate to finance See's substantial annual build-up of pre-Christmas inventories. Obviously, based on See's 1982 earnings of $12.7 million, this investment in See's is worth considerably more than its carrying value in Blue Chip's consolidated balance sheet.

Last year we stated that See's would try again to increase earnings in 1982 and that a modest increase was quite conceivable. This same statement now seems appropriate with respect to 1983.

MUTUAL SAVINGS AND LOAN ASSOCIATION

Our equity in Mutual Savings' operating income declined slightly in 1982 to $3,296,000 from $3,393,000 in the previous year.

The 1982 operating income equity of $3,296,000 is before deduction of Blue Chip's $1,943,000 share of an after-tax loss from Mutual Savings' sale last year of mortgage-backed securities. This special loss contribution of $1,943,000 has been included, instead, in computing "Net Gains on Sales of Securities, Mortgages and Important Fixed Assets," the final category in our earnings breakdown for purposes of this letter.

Earning any operating income at all was an achievement because in 1982 almost all other savings and loan associations suffered operating losses. The generally poor results are caused by a borrowed-short, lent-long position, combined with high current interest rates associated with past and anticipated inflation and removal of much former regulation limiting

rate competition for savings accounts. Associations have been forced to pay interest rates to hold savings accounts which are higher than can be covered by locked-in yields from long-term, fixed-rate mortgages acquired years ago in what now seems like a different world.

The sorry state of the savings and loan industry is one more example of the operation of Garrett Hardin's principle for soft sciences (like business, politics, economics and law) that bad ideas are born good. A well-intentioned idea of some kind works fine for a while, then stops working and goes into reverse, as did the basic savings and loan idea of borrowing short and lending long to an extreme degree while depending on governmental regulation to force savers to take an inadequate return. If, as seems likely, Hardin's principle is part of an inevitable human legacy, tragedy can be averted, partially, only by reversing course when the danger flags start flying as the cherished ideas of the past are faithfully followed. Unfortunately, another perverse phenomenon interferes here — the tendency of the mind to reject the message from a danger signal which is inconsistent with a cherished idea.

At Mutual Savings we were too blind for too long, exactly as Hardin would have predicted, but like the rest of the savings and loan industry we started coping better with reality when it stopped waving the danger flags at us and started using them to poke us in the head and stomach.

The eventual result of our efforts to cope with reality, including a massive sale of branch offices, has been that Mutual Savings has continued to earn a modest amount of operating income despite having a substantial borrowed-short, lent-long position, including a fixed-rate mortgage portfolio bearing what is probably the very lowest average interest rate among all U.S. associations (7.4% per annum at the end of 1982). The 1982 operating income occurred, notwithstanding this handicap, because Mutual Savings has had:

1. so far as we know, a higher ratio of shareholders' equity to total interest-bearing liabilities than any other mature U.S. association;
2. a higher-than-normal proportion of assets in short-term, interest-bearing cash equivalents; and
3. a far-higher-than-normal proportion of assets in intermediate-term, tax-exempt bonds and utility preferred stocks producing a tax-equivalent yield of about double that prevailing on the mortgage portfolio of the typical association.

Mutual Savings' balance sheet at the end of 1982 is set forth in summary form in Note 1 to our accompanying financial statements.

Mutual Savings' unusual asset-liability structure was caused in part by the sale in 1980 of all its branch offices, one incident of which was retention of only the lowest-yielding mortgages, albeit those with the shortest remaining terms. In selling all branch offices in 1980 as interest rates were rising, the institution shortened sail to allow for hurricane conditions, not because a hurricane was clearly foreseen, but because of the effect that being poked with danger flags had on our generally cautious nature. A hurricane came in 1981, the end of which is yet to be seen, although industry conditions are now considerably improved from their worst state, due to a substantial decline in interest rates incident to recession.

What Mutual Savings has left is a less-than-mediocre business in terms of the return it earns on the capital it employs. As it keeps its books it had $46.2 million in shareholders' equity at the end of 1981, on which its operating income was of less-than highest quality and amounted to only $3.3 million in 1982, or at the inadequate rate of 7.1% per annum. (The operating income was of less-than-highest quality because it came largely from tax savings through inclusion in its parent's consolidated income tax return, and such income, while real, has less cushion in reserve against future adversity than the highest quality income on which full income taxes have been paid in cash and are recoverable from the IRS in the event of future losses.) However, as Blue Chip reports earnings from its equity in this less-than-mediocre business, the results are considerably better because Blue Chip's equity was originally purchased at a large discount from its book value on the books of Mutual Savings. At the end of 1981 Blue Chip's equity in Mutual Savings was carried in Blue Chip's consolidated balance sheet, net of minority interest, at $18.2 million, and this equity contributed $3.3 million to Blue Chip's consolidated operating earnings in 1982, or at the rate of 18.1% per annum, including $.6 million of amortization into income, at the rate of 1/40th per year, of the discount from book value at which the equity originally was purchased.

Some additional perspective on the current situation may be obtained by examining the following table:

Calendar year	Blue Chip's average equity in Mutual Savings as carried in Blue Chip's consolidated balance	Blue Chip's share of the cash dividend paid by Mutual Savings during the	Annual percentage return on Blue Chip's equity from the Mutual Savings

	sheet	year	dividend
1975	$11,975,000	$1,932,000	16.1%
1976	20,570,000	3,226,000	15.7
1977	23,928,000	3,845,000	16.1
1978	25,285,000	5,287,000	20.9
1979	25,630,000	6,728,000	26.3
1980	22,381,000	9,852,000	44.0
1981	18,778,000	1,922,000	10.2
1982	20,965,000	801,000	3.8

This table pretty well reflects the essence of real, and on balance quite favorable, economic effects on Blue Chip shareholders caused by Blue Chip's acquisition of a large interest in Mutual Savings.

In last year's letter we reported that we expected Mutual Savings to pay no dividend at all in 1982. Instead, despite the loss from an unusual sale of mortgage-backed securities, a modest 1982 dividend was paid, as reflected in the table above, and we now guardedly forecast a larger dividend from Mutual Savings in 1983. Any increase would be welcome, because the present dividend return on Blue Chip's carrying value of its investment is inadequate, and not in any small degree.

Operating a savings and loan association under the more competitive conditions which will almost surely prevail in the future as a consequence of deregulation of rates of interest paid to savers is going to present a challenge which, so far, we haven't fully figured out how to meet. We are sobered by the examples of deregulation effects presented by trucking companies and airlines, and by the possibility of shocks to the whole bank/savings and loan system which now appear more conceivable than at any other time after World War II. National legislators in both political parties, pressured by our financial institutions, have recently augmented the hermaphroditic part of the bank/savings and loan system, where deposits are insured (in effect) by the U. S. Treasury while interest rates paid to depositors on those deposits can be (roughly) whatever an insured institution decides to pay. We hope we are wrong in foreseeing, from the recent changes in the system, increased encouragement of what in the long run will be unsound practice by institutions needing encouragement in precisely the opposite direction.

We do have one central determination: to preserve a lot of options by retaining financial strength and by remaining very flexible with respect to expansion (including acquisition), contraction and revisions of services designed to create more differentiation in the market place from standard financial services provided by others.

We do not have any intention to sell Mutual Savings. We hope that it will ultimately find a way to earn higher profits, sufficient at least to permit payment of dividends causing realization of a more satisfactory rate of return on the carrying value of Blue Chip's equity.

No savings and loan executive has had an easy time in the last few years. Louis Vincenti, chief executive of both Mutual Savings and Wesco, is no exception. In our view the record he has created is better than those of his peers, reflecting both unusual talent and a very high sense of stewardship for savers and shareholders.

PRECISION STEEL WAREHOUSE, INC.

Our 80%-owned Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, was acquired for approximately $15 million on February 28, 1979. Our 80% share of the price was thus about $12 million. It owns a long-established steel service center business and a subsidiary engaged in the manufacture and distribution of tool room supplies and other products sold under its own brand names. Precision Steel's operating businesses contributed $276,000 to our consolidated net income in 1982 compared with $1,560,000 in 1981. The decrease in earnings was caused by a continuation of (1) severe recessionary conditions in the steel industry, and (2) effects of a business mistake, now corrected at substantial cost, namely entry into a small measuring-tool distribution business, closed down in 1982.

Even under recessionary conditions operations remain profitable, and we anticipate at least some improvement in earnings for 1983.

The minimum shareholders' equity, at Blue Chip's carrying value per unit of equity, required to own and operate 100% of Precision Steel's business at its 1982 level is about $13 million on which the business earned $.3 million in 1982 or at a very inadequate rate of 2.3% per annum.

We knew when we purchased Precision Steel that earning a return, satisfactory under inflationary conditions, on the unleveraged equity capital required to operate its business would be difficult, and we supplied some leverage by borrowing the purchase price, refinancing at a fixed rate as soon as practicable. We ordinarily have reservations concerning financial leverage but are willing, as in this case, to borrow money to purchase as part of our mix of businesses a clean and moderately profitable company like Precision Steel where inventories carried on the LIFO basis represent a substantial part of total assets and where reported earnings are expected usually to turn up in cash, absent optional expansion.

After acquisition, as above reported, Precision Steel's earnings have been a disap-pointment, but its facilities and balance sheet remain in first-class shape.

Both Mutual Savings and Precision Steel are owned by Blue Chip Stamps through 80% control of Wesco Financial Corporation, a public company with shares traded on the American Stock Exchange. For more complete information, we encourage Blue Chip shareholders to obtain a copy of Wesco's 1982 annual report. Simply make your request to:

Wesco Financial Corporation
315 East Colorado Boulevard
Pasadena, California 91109
Attention: Mrs. Jeanne Leach, Treasurer

BUFFALO EVENING NEWS, INC.

The operating loss, before taxes, of our 100%-owned newspaper subsidiary, Buffalo Evening News, Inc., in 1982 was higher than that of 1981, increasing marginally to $1,270,000 from $1,091,000 in the previousy ear Thus the surface indication from our newspaper figures for the full year 1982 would app. ear to be that we were correct last year when we stated with respect to the News: "We confidently predict a lack of improvement [in the News' 1982 operating figures]. We anticipate terrible market conditions for the News in 1982."

However, the underlying reality as we enter 1983 is quite different from the poor situation forecast in last year's letter to stockholders. What we failed to foresee last year was the business failure of the Courier Express, the News' most important competitor in Buffalo, which ceased publishing its newspaper on September 19, 1982, leaving the News as the only area-wide metropolitan daily newspaper in Greater Buffalo, New York.

Before the failure of the Courier Express the News and its employees were locked into an intense survival struggle in a recession-plagued market (albeit a fine city). The outcome of this struggle was always uncertain. Now the economic prospects for both the News and its employees are improved from the extremely hazardous state which formerly existed. Indeed, profits were earned in November and December of 1982 adequate to offset a major portion of extraordinary costs and losses incident to circulation-building, including start-up of the News' first weekday morning edition, after the Courier Express stopped publishing in September. We now expect the News to be profitable for the full year 1983. Our eventual target is a 10% margin on sales after taxes, and we hope to be well over halfway to this target in 1983. Our target return on sales is somewhere close to the norm for newspaper operations like the News.

We will not here repeat in detail our long account of the competition and litigation in Buffalo between the News and the Courier Express. That chapter has ended. Shareholders who wish to refresh their memories should read the section about the News in last year's letter. Highlights of an up-dated history from our acquisition of the News in 1977 through year-end 1982 are as follows:

1. We purchased the News for about $34 million in April, 1977.
2. The News lost about $12 million, before taxes, after our acquisition and through December 31, 1982.
3. The after-tax effect of these losses reduced the carrying value of our News subsidiary in our consolidated balance sheet to about $28 million at the end of 1982. (In addition, of course, we have realized no return at all for a great many years from employment of the $34 million originally expended in buying the newspaper, and we would have realized a substantial and compounded return if we had invested the money elsewhere.)

4. However, the newspaper which we owned at the end of 1982 is a much better business operation than the newspaper we purchased in April of 1977. The following comparisons indicate the rough dimensions of change at the News:

	In April, 1977	At 12/31/82
Weekday circulation	279,000	323,000
Saturday circulation	300,000	271,000
Sunday circulation	-0-	354,000
Estimated revenues for next 12 months	$43,000,000*	$85,000,000+

- Represents approximate actual revenues for twelve months beginning April 1977.

As this is written, the News ranks 21st among the nation's daily newspapers in weekday circulation, which was about 321,000 in February, 1983. At the same time Sunday circulation was about 367,000. Notwithstanding economic decline in Buffalo the present Sunday circulation of the News is 95,000 higher than the 272,000 Sunday circulation of the Courier Express in 1977 when it alone published a Sunday edition!

Plainly, considering the ambitions of other publishers to add to their newspaper holdings, the News could now be sold for considerably more than the amount at which it is carried in Blue Chip's consolidated balance sheet. However, we have no interest in selling. We are proud of the News and of our association with its people — including Henry Urban, Stan Lipsey, Murray Light, Clyde Pinson, Dave Perona, Dick Feather and many more — who have led the News to its present position. We are proud, too, that we have nourished as well as we have the journalistic tradition we inherited from the News' legendary Editor, Alfred H. Kirchhofer, predecessor to Murray Light. We hope to be better known as the years pass as good stewards of good traditions, as we believe we have been at both the News and See's.

Although the News is now a much stronger economic operation than it was last year, it nonetheless occupies no bower of roses, for the following reasons, among others:

1. Metropolitan newspapers as a group have lost advertising market share to electronic media in recent years. Newspaper publishing is inherently a very intense user of resources, energy and human time, compared to many other media, the influence of which is growing, assisted by rapidly improving technology. Newspaper costs have escalated more rapidly in some recent years than utility to advertisers, particularly at some large, old newspapers. One cause is newspaper inability, because of provisions in labor contracts, to realize anything like the full reduction in various costs possible with modern automation, while competitors not so restricted gain full benefits from technological change.

2. Competition from free publications and suburban newspapers has increased in vigor.

3. Retailing has increasingly been concentrated in chain-store operations which have learned how to deliver advertising circulars without using newspapers and often do so when dissatisfied with newspaper run-of-press or pre-print advertising rates.

4. Buffalo has suffered and continues to suffer from far more than its share of the national recession. Unemployment has been as high as 15.3%, and many large and important retailers have gone out of business, shrinking the total amount of advertising available to newspapers by millions of lines per year. It was this extreme Buffalo-area business decline, plus general conditions making it difficult or impossible for two competing newspapers to survive, even in cities with above-average prosperity, which combined to cause Buffalo to become yet another American city with only one area-wide metropolitan newspaper. As things worked out, the News may well have realized some advantage as well as disadvantage as recent, above-average business misery in Greater Buffalo contri-buted to the disappearance of a major competitor. But any continuation of local business decline from this point will be a pure curse for the News. All managers know that it is easier to keep both owners and employees happy in a business in an expanding market, instead of a declining one. Shrinking-pie division is usually more troublesome and controversial than expanding-pie division.

These are not small problems, and in a few other cities (some more prosperous than Buffalo) without economic

competition between two area-wide metropolitan newspapers, we surmise that little or no profit is now being earned by the metropolitan newspaper operation.

Finally, our shareholders should recognize that if our 1977 purchase of the News has now worked out acceptably from their viewpoint, which contrary to our prediction last year may now be true even after taking into account time delays, the conclusion does not follow that we made a sound managerial decision buying the News when we did for the price we paid. In retrospect, we were strongly influenced because we liked the newspaper, its people and the city, and we may simply have gambled shareholders' money against the odds and won. Our stewardship may have been, at best, dubious in this instance. We know that the financial outcome we now report could with slightly different breaks just as well have been either (1) a large loss on closure of the News or (2) the expectation of much more money-losing in continued operation, as part of the only defensive strategy with reasonable prospects.

PROMOTIONAL SERVICES BUSINESS AND MISCELLANEOUS SOURCES OF OPERATING INCOME

The final components of our consolidated net operating income last year were provided by (1) operating earnings from our promotional services (mainly trading stamp and motivation) business, after deduction of interest and other general parent company expense, plus (2) our share of operating earnings, after deduction of interest and other Wesco general corporate expense, from securities and real estate held by Wesco outside the savings and loan and steel service activities of its subsidiaries.

The promotional services business operated at a slightly increased profit, after parent company interest and other general expense and income taxes, last year, up to $4,212,000 from $3,659,000 after (properly) giving it credit for the entire income (dividends and interest, plus income tax benefits caused by dividends) from investment of the funds available through (1) "float" caused by trading stamps issued but not yet redeemed plus (2) a reasonable amount of shareholders' equity capital. Our shareholders should not be encouraged by the increase in after-tax profit, which was attributable in part to the fact that favorable revisions in our estimates of our liability to redeem outstanding trading stamps were made in 1982 but not in 1981 and in part to increased shareholders' equity capital. The revisions in redemption liability, which by their nature will not frequently recur, increased 1982 after-tax profit by $339,000.

Moreover, as we forecast in last year's letter, trading stamp service revenues declined drastically in 1982 to $9,203,000 from $15,619,000 in 1981. The Stater Bros. supermarket chain, which accounted for 51% of our trading stamp revenues in 1981 discontinued giving trading stamps on April 1, 1982, and we have not replaced the lost revenue. The main good news coming out of our trading stamp business last year was an increase in sales to service stations, attributable to very intense competition caused by the current gasoline glut, plus some heartening examples of customer success after adoption of our programs.

Our continued substantial profits in the trading stamp business, in the face of huge decreases in sales, are made possible only by the slow departure of "float" from trading stamps sold in earlier and better years. This "float" — resulting from past issuance of trading stamps when volume was many times greater than the current level — is very large in relation to current issuances. (Trading stamp revenues peaked at $124,180,000 in fiscal 1970, and our 1982 revenues of $9,203,000 therefore represented a decline of 93% from peak volume.) Eventually, unless stamp issuances improve, earnings from investing "float" will decline enormously. And, since the trading stamp business already operates at a loss before taking investment revenues into account, such future declines in "float" will aggravate what is already a poor situation. This happens because any significant decline in non-investment revenues is inevitably more rapid than the related decline in costs. Such is the normal result for any operator of a chain of retail stores (like our trading stamp redemption stores) whose "same store" sales decline in dollars from year to year.

Under such conditions it has been helpful to us that our decline in "float" in recent years has proceeded at so extremely slow a rate, leaving our reserved liability for trading stamp redemption at $60,240,000 at yearend 1982, down only 6.3% from yearend 1981.

As discussed extensively in previous annual reports (particularly for fiscal 1976), which we urge shareholders to review, accounting for trading stamp redemption liability (which involves estimating the number of stamps that will ultimately be redeemed and the cost per stamp) is a difficult process under any circumstances, but particularly so in an inflationary economy and when stamp issuances decline by a large percentage. We periodically revise our estimated future redemption liability as conditions warrant. In 1982 we made revisions increasing operating income as above described,

as explained in detail in Note 2 to our accompanying financial statements. Recent changes, including that in 1982, both decreased our estimates of stamps ultimately to be redeemed and increased our estimates of total redemption costs per stamp. Merchandise cost per stamp redeemed has remained relatively constant as volume has declined, and we hope this state of affairs will continue. Non-merchandise or redemption service cost per stamp redeemed is another story. Such cost per stamp is now virtually certain to go up sharply from last year's level as stamps redeemed in the future share store and warehouse operating expense which cannot be reduced at the same rate as redemptions. The 1982 changes take all the foregoing into account.

A higher proportion of non-merchandise costs in our redemption liability has an unfortunate income-tax effect, diminishing true "float" per dollar of book liability. The cash available to us for use from aggregate redemption liability as reported in our books is always considerably lower than the amount of liability shown. One cause is U. S. Treasury regulations (which we have conformed to despite doubting their legality) which do not allow us to deduct for income-tax purposes future redemption service cost (for instance, store operating expense) as distinguished from future merchandise cost. Both types of cost are unavoidable and require accrual of real liabilities in our audited financial statements. The cash-use consequences of the divergence (all of which is not caused by the U. S. Treasury regulation cited above) of IRS-specified income-tax accounting and our audited accounting are substantial. For instance, out of our total trading stamp redemption liability as we report it of $60,240,000 at yearend 1982, we must leave $17,175,000 in a non-interest-bearing deposit with the U. S. Treasury, designated "prepaid income taxes" in our balance sheet.

We remain convinced that trading stamps are an effective point-of-purchase sales promotion device for supermarkets, service stations, bowling alleys and the like. We intend to remain in the trading stamp business.

In our related motivation business revenues decreased slightly in 1982 to $1,351,000 from $1,446,000 in 1981. Revenues are expected to increase in 1983.

One final item augments our consolidated net operating income. Our share of operating earnings, after deduction of interest and other Wesco general corporate expense, from securities and real estate held by Wesco outside the savings and loan and steel service activities of its subsidiaries, amounted to $2,838,000 in 1982 compared with $2,167,000 in the previous year.

NET GAINS ON SALES OF CORPORATE SECURITIES, MORTGAGES AND IMPORTANT FIXED ASSETS

In our total assets, located among our five operating businesses, we hold considerably more corporate securities than might be expected in a consolidated enterprise of our size at the close of 1982 as we report consolidated revenues of $252 million and consolidated net worth of $218 million (see Note 3 to our accompanying consolidated financial statements).

Most of these holdings of corporate securities are held because of the very nature of the particular business in which they are owned. For instance, the trading stamp business owns liquid assets to provide for ultimate redemption of stamps, and the savings and loan business holds liquid assets to provide for repayment of savings account holders. The remaining security holdings exist temporarily, primarily in Wesco Financial Corporation, pending their disposition to provide funds for use in buying additional businesses.

Only Mutual Savings, which until January 1, 1983 was barred by law from owning most common stocks, has significant holdings of preferred stocks. Most holdings, therefore, are of common stocks. Our reported operating earnings include only the dividends from our stockholdings, after taxes. And, because the corporations whose common stock we own also have and reinvest earnings not paid out as dividends, a process which ultimately raises market value of the stock we own, we also realize irregularly net capital gains from sales of portions of our holdings.

In addition, our various businesses occasionally sell important buildings, machinery or other fixed assets, as such businesses adjust to changing conditions. No significant sale of fixed assets occurred in 1982.

Our aggregate share of all types of special net gains combined, after income taxes, was $23,101,000 in 1982 compared with $6,731,000 in 1981. All the 1981 net gain came from the sale of securities. The 1982 share of net gain consisted of $25,044,000 from sale of securities, offset by $1,943,000 in net loss from Mutual Savings' sale of mortgage-backed securities. The 1982 share of net gain from sale of securities included $23,901,000 from disposition of our entire holdings

in Pinkerton's, Inc., discussed in the next section of this letter.

PINKERTON'S, INC.

Pursuant to a contract made in 1982 we received cash from American Brands early in 1983 for our entire Pinkerton's holding. The after-tax gain of $23,901,000 is included in our 1982 financial figures.

The holding sold consisted of non-voting stock representing 37% of the equity in Pinkerton's, long the leading national security and investigation service company.

Our ownership of this non-voting interest demonstrates that, when all factors are considered, we often would rather buy stock we can't or won't vote than absolute control. We think the rationality of use-of-capital decisions is improved when the repertoire of a corporate manager includes purchases of business interests which do not augment the number of people to whom the manager can give orders. However, we have generally observed a low interest among corporate managers in passive investments, even when available at much better price/earnings and price/book value ratios than controlling positions. The strong preference for controlling positions is ordinarily justified by (1) expected improvements from a change in control based on a high appraisal of the business skills of the managers of the corporate investor compared to the managers of the corporate investee and (2) a low appraisal of the likelihood that the managers of the corporate investee, if free to act independently, will make decisions which best serve the interests of ultimate shareholders. Our view is different, and, although we have always expected to concentrate our activities primarily in operating businesses, we also have an uncommon interest in passive positions for the following reasons:

1. We know that our business skills are frequently inferior by a wide margin to those of others, as we can prove from comparative figures and our audited record reflecting gross errors;
2. We believe that many corporate managers can be trusted to serve the shareholders' interests even when the shareholders have no practical power to control or replace management;
3. We think the advantage of buying at a non-premium price, because control is absent, often counterbalances the disadvantage, if any, from lack of control;
4. Our consolidated enterprise includes operating businesses required by their nature to own significant passive investments.

We hope to become better known for an uncommon willingness to own "nonvoting-partnership" interests in businesses and to attract other offerings like that which produced our Pinkerton's holding. And we are sure, based on six years' observation from our non-voting position, that Pinkerton's wouldn't have been managed or merged one whit better or one whit more in its shareholders' interests if we had purchased voting control.

Only the dividends we have received from Pinkerton's are included in our reported operating income. These dividends were increased regularly in recent years, creating part of the income reported above under the heading: "Promotional Services Business and Miscellaneous Sources of Operating Income." The part created by Pinkerton's dividends was $2,011,000 in 1982 and $1,730,000 in 1981.

There will, of course, be no future operating income from Pinkerton's dividends, only income from reinvesting the $47,265,000 after-tax proceeds of disposition of the Pinker-ton's holding. Our average compounded, after-tax return from owning non-voting Pinker-ton's stock was 15% per year, merging the effects of both dividends over the years and the final large capital gain included in the portion of our 1982 income listed above under the heading "Net Gains on Sales of Corporate Securities, Mortgages and Important Fixed Assets."

CONSOLIDATED BALANCE SHEET AND OTHER DATA

Our consolidated balance sheet retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others. As explained in Note 3 to the accompanying financial statements, the aggregate market value of our marketable securities was higher than their aggregate cost at December 25, 1982. In addition, an office building and related real estate owned by Wesco Financial Corporation has a market value substantially in excess of carrying value. We remain in a prudent position when total debt is compared to total net worth and total liquid assets.

Retaining the impeccable bank credit facilitated by a prudent balance sheet position has always been very important to us. When combined with our practice of doing a certain amount of long-term borrowing in advance of specific need,

impeccable credit has given us maximum financial flexibility to face both hazards and opportunities.

Sections entitled "Principal Business Activities," "Selected Financial Data" and "Management's Discussion and Analysis" are presented immediately following this letter. We invite your careful attention to these items and to our audited financial statements.

A LOOK BACK AND A LOOK AHEAD

We began the 1970s with a single business, trading stamps, which was destined to decline to a small fraction of its former size, and a portfolio of securities, offsetting stamp redemption liability, which had been selected by previous owners and would have led to a disastrous result if held through to the present time. (The portfolio, for instance, contained a substantial amount of very-long-term, low-coupon municipal bonds of issuers with declining credit ratings.)

We began the 1980s with five constituent businesses instead of one. In order of acquisition they are: (1) trading stamps and other promotional services, (2) See's Candy Shops, Incorporated, (3) Mutual Savings, (4) Buffalo Evening News, and (5) Precision Steel.

Our five constituent businesses have more in common than might be noted by a casual observer:

1. They are all high-grade operations suffused to a considerable extent with the business ideas of Benjamin Franklin, manned by high-grade people operating within a long tradition emphasizing reliable and effective service, and
2. When functioning properly each business will usually generate substantial amounts of cash not claimed by compulsory reinvestment in the same business and therefore available for purchases of new businesses or debt repayment.

The second of these two common characteristics gets more important every year as inflation continues. Many businesses, once good investments when inflation was low, are now, under inflationary conditions, unable to produce much, if any, cash even when physical volume is constant. Any such business, always cash-starved at constant physical volume, even while reporting apparently satisfactory profits, is a very dubious candidate, absent some special factor, for acquisition by a rational acquirer.

Our balance sheet net worth at March 3, 1973 was about $53 million. By the end of 1982 our balance sheet net worth had increased to approximately $218 million, up 311% in ten years, after payment of regular dividends. At March 3, 1973 our equity in aggregate securities was worth about $4 million more than balance sheet cost. At the end of 1982 this equity was worth about $27 million more than balance sheet cost. Our average annual total percentage return earned on shareholders' investment over the ten years ending December 25, 1982 was approximately 16.7% per annum, without taking into account (1) the increase from $4 million to $27 million in unrealized appreciation in our equity in marketable securities or (2) unrealized net appreciation in such subsidiaries as See's and the Buffalo Evening News. The percentage return earned was acceptable in a moderate inflation environment, considering the headwinds in our initial trading stamp business.

In 1982, the year just ended, our total percentage return on the beginning investment of our shareholders was approximately 27%. This percentage return fluctuates from year to year depending upon various factors including changes in amounts of capital gains realized. The percentage return figure for any one year is not very significant, although the average figure over a period of years, and the trend in such average figure, are of vital importance.

In the future we hope to earn a higher average (though sharply fluctuating) annual total percentage return on shareholders' investment — at least for a while until we are dragged down by some law of regression toward mean results, an outcome sure to occur eventually at any corporation which retains a high proportion of its earnings. Some short-term prospects are favorable, for instance, the prospect that the Buffalo Evening News will have earnings in 1983, compared to a loss in 1982. Furthermore, we expect from time to time to acquire additional businesses which eventually will produce higher returns than the assets disposed of to fund their purchase.

However, even if above-average returns on shareholders' equity are earned for a long time in the future — far from a sure thing — the inflation problem for our shareholders will not automatically be solved. As we point out year after year, "A 16% return on equity obviously won't do much in real terms for shareholders if the inflation rate is 16%, or even 11% when we also allow for income taxes imposed on owners who must report taxable 'profits' while only maintaining their position on the purchasing-power treadmill."

Inflation is a very effective form of indirect taxation on capital represented by holdings of common stock. We know of no adequate countermeasure, generally available to corporate managers who wish to protect shareholders, to this form of indirect taxation. But, even so, we think a habit of always thinking about and trying to serve shareholders' interests in real terms, instead of rationalizing growth of managed assets regardless of real effects on shareholders, is quite useful and may fairly be expected of corporate managements. We make a very conscious effort, perhaps with occasional inadvertent lapses, to have and reinforce this habit.

For one example, low stock prices, caused by inflation, together with our preoccupation with real shareholder interests, have intensified our resistance to most proposals that we issue new common stock. We haven't issued a new share, for any reason, for a long time. With rare exceptions American corporations now cannot get as much intrinsic value as they give when new common stock is issued. Our corporation is no exception. And, quite clearly, a corporation can't further its own shareholders' long-term interests by diluting, through new stock issuances, the intrinsic value underlying each outstanding share. Our unwillingness to accept any such dilution explains our long-unchanged common stock capitalization.

Even in the presence of the moderation in inflation caused by the current severe recession, we think the likelihood of future inflation remains high in the United States, as well as in other modern democracies. In a sense the current recession has compounded the inflation problem by demonstrating that a conscientious corporate manager must take precautions not only against inflation but also against severe slump — no small order, considering the inherent contradictions involved.

Current conditions have only intensified our long-standing belief that a (1) heavy managerial emphasis on the cash-generating characteristics of businesses, (2) managerial reluctance to issue new stock and (3) strong balance sheet position are all likely to enjoy increased recognition in future years as qualities to be emphasized by selectors of common stocks for investment.

This may well be the last annual report our shareholders will ever receive from Blue Chip Stamps as a separate corporation, because work is in progress on a proposal that our corporation be merged with Berkshire Hathaway Inc., long a 59.6%-owner of Blue Chip Stamps. If such a merger occurs, our shareholders will become holders of common shares of Berkshire Hathaway Inc. We will not here further discuss merger possibilities, because such discussion will be contained in a formal merger proposal and proxy statement, which Blue Chip shareholders will receive in due course if such a proposal is approved by the board of directors of each corporation.

Cordially yours,

Charles T. Munger, Chairman of the Board
Donald A. Hoeppel, President

February 17, 1983

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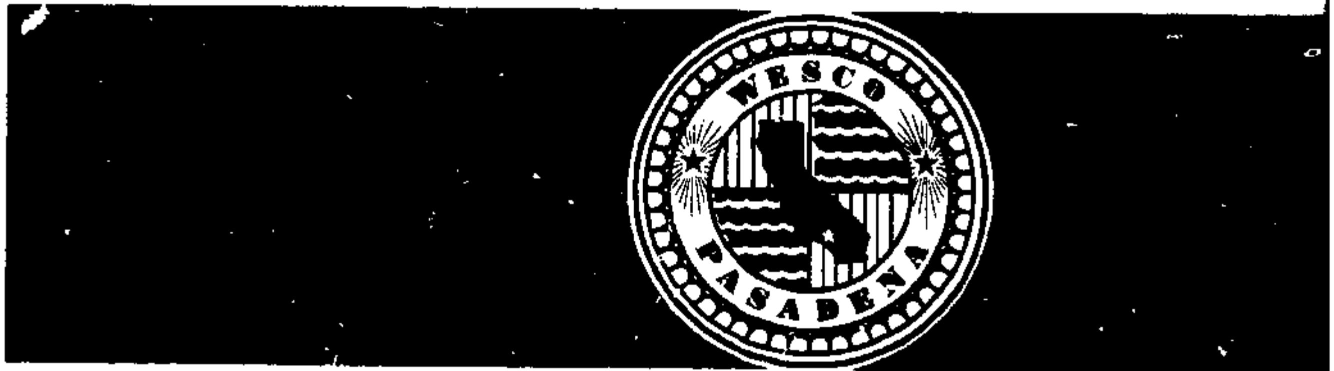


WESCO FINANCIAL CORPORATION

Annual Report 1983

Form 10-K Annual Report 1983

WESCO FINANCIAL CORPORATION

LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated ordinary operating income (i.e., before all net gains from sales of securities, mortgages and important fixed assets) for the calendar year 1983 increased to $8,507,000 ($1.20 per share) from $7,221,000 ($1.02 per share) in the previous year.

Consolidated net income (i.e., after net gains from sales of securities, mortgages and important fixed assets) decreased to $10,553,000 ($1.48 per share) from $11,502,000 ($1.62 per share) in the previous year.

Wesco has two major subsidiaries, Mutual Savings, in Pasadena, and Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts):

Year Ended	Ordinary Net Operating Income of Mutual Savings	Ordinary Net Operating Income of Precision Steel Businesses	All Other Ordinary Net Operating Income[1]	Net Gains on Sales of Securities, Mortgages and Important Fixed Assets[2]	Wesco Consolidated Net Income
December 31, 1983 ...	$3,046	$1,622	$3,839	$2,046	$10,553
Per Wesco share	.43	.23	.54	.28	1.48
December 31, 1982 ...	3,482	327	3,412	4,281	11,502
Per Wesco share	.49	.05	.48	.60	1.62

(1) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings' headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan subsidiary.

(2) The 1982 figures include $6,706,000 or $.94 per Wesco share of net securities gains realized throughout the consolidated enterprise, offset by a loss incurred on sale of mortgage-backed securities of $2,425,000 or $.34 per Wesco share. The 1983 figures relate entirely to such net securities gains. All figures are net of taxes.

The foregoing breakdown (of the same aggregate earnings) differs somewhat from that used in our audited financial statements and press releases, which follow standard accounting convention. The supplementary breakdown of earnings is furnished because it is considered useful to shareholders.

Mutual Savings

Mutual Savings' ordinary net operating income of $3,046,000 in 1983, represented a decrease of 12.5% from the $3,482,000 figure the previous year. In both years such ordinary net operating income, while economically real and probably of at least average quality as reported savings and loan industry incomes go, was below the top quality possible because such earnings came from income tax savings obtained through inclusion of Mutual Savings in the consolidated income tax return of a parent corporation. Earnings so derived from income tax savings are not of the top quality possible because they have less cushion in reserve against future adversity than earnings from ordinary operating income on which income taxes have been paid in full in cash at the highest corporate rate and are recoverable from the I.R.S. in the event of future operating losses.

Separate balance sheets of Mutual Savings at yearend 1982 and 1983 are set forth at the end of this annual report. They show (1) total savings accounts rising to $203 million from $168 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (probably the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, and (4) a mortgage loan portfolio of about $106 million at the end of 1983, down 12% from the $121 million at the end of 1982. The mortgage loan portfolio at the end of 1983 bore a fixed average interest rate of only 7.48%, probably the lowest for any U.S. savings and loan association and far below the average interest rate which now must be paid to hold savings accounts.

The capital-rich, mortgage-loan-interest-rate-poor position of Mutual Savings came from (1) success many years ago as a construction lender at above-average interest rates, plus (2) sale in 1980 by Mutual Savings of all branch offices (except for one satellite office in a major shopping center across the street from the Pasadena headquarters) under terms where only the lowest-yielding mortgage loans from its large portfolio were retained, plus (3) drastic curtailment by Mutual Savings of mortgage lending following the sale of its branch offices.

Mutual Savings has remained profitable because the adverse effects from its low-yielding, fixed-rate mortgage loan portfolio are more than offset by favorable effects from its large shareholders' equity and a tax-equivalent yield on its marketable securities (utility preferred stocks, tax-exempt bonds and common stocks) considerably higher than that prevailing on the mortgage loan portfolio of a typical savings and loan association. The low-yielding, fixed-rate mortgage loan portfolio has shrunk from pay-backs at 8.5% per year over the last three years, and the shrinkage is expected to continue at about the same rate.

Mutual Savings has adapted in its own way to the dramatic changes which have occurred in recent years in interest rates and the regulatory structure of the banking and savings and loan industries. At Mutual Savings, as well as the rest of the savings and loan industry, the standard practice used to be to borrow short from savers while lending long on fixed-rate mortgages, to have high financial leverage for shareholders' equity and to grant mortgagors easy prepayment terms. The practice was profitable for decades but always involved something like a "hurricane risk," and the equivalent of a hurricane came in 1981-82 as interest rates rose to unprecedented levels and caused widespread losses. Results were good for shareholders before 1981-82 only because interest rates were stable or rose slowly as mortgage-loan portfolios steadily and rapidly expanded under a regulatory structure which both fostered growth and protected operating margins by requiring that on all insured savings accounts fixed rates be paid that were slightly higher than the low rates specified for banks. Thus a small deposit-attracting rate advantage over banks was given to savings and loan associations, while competitive pressure was dampened for both types of institution.

Although interest rates have subsided from the 1981-82 peak, the low and slowly changing interest rates of former years are plainly gone with the wind, as are the former government-decreed limits on interest rate competition for savings accounts and the favoritism for savings and loan associations over banks. But an agency of the U.S. government (F.S.L.I.C.) continues to insure savings accounts in the savings and loan industry, just as it did before. The result may well be bolder and bolder conduct by many savings and loan associations. A sort of Gresham's law ("bad loan practice drives out good") may take effect

for fully competitive but deposit-insured institutions, through increased copying by cautious institutions of whatever apparent-high-yield loan and investment strategies seem to allow competitors to bid away their savings accounts and yet report substantial earnings. If so, if "bold conduct drives out conservative conduct," there eventually could be widespread insolvencies caused by bold credit extensions come to grief.

And if serious credit-quality troubles come to the savings and loan industry, they will merely add to troubles from the borrowed-short, lent-long-at-fixed-rates problem, which is far from completely removed, and which destroys shareholder wealth at startling speed whenever interest rates are rising rapidly, even when the credit quality of mortgagors or other borrowers is excellent.

Developing a short-term operating plan for Mutual Savings which would sharply increase its reported earnings next year would be a near-absolute cinch. For instance, savings accounts could be expanded greatly by paying a high rate of interest on "jumbo" deposits in $100,000 multiples, and proceeds plus cash equivalents on hand could be placed in long-term mortgages at a substantial current interest spread while, in addition, some origination fees could be "front-ended" into income. However, taking long-term risks into account, it is much harder to find a sound operating plan. Money is the ultimate fungible commodity. In the new order of things, an association is not only in a tough, competitive, commodity-type business on the lending side but also finds that, with decontrol of government-insured rates paid savers, every competitive association has virtually unlimited credit to fund increased lending, by paying premiums over interest rates generally prevailing on savings accounts. Under such conditions, when all risks are considered, including those created by that portion of competitors motivated primarily by short-term effects, it is quite naturally difficult to earn over a long period an attractive return on shareholders' equity. How could it be otherwise?

A few years ago, about the time Mutual Savings reacted to new conditions by curtailing lending, most other associations decided instead to keep lending aggressively but under new adjustable-rate mortgages under which some portion (but far from all) of the interest-rate-fluctuation risk is shifted to the homeowner. Despite widespread use of these new adjustable-rate mortgages, savings and loan industry earnings remain dependent to a material extent, as they always were, on an interest rate spread attributable to: (1) borrowing short while lending long, and/or (2) making loans which can be priced high enough to provide a profit only because they involve a very material credit risk, compared to the risk of owning government-backed securities of comparable maturity.

Under present conditions of strong competition from bold competitors accompanied by high interest-rate-fluctuation risk, the result tends to be that each year of reported attractive earnings occurs only in the absence of two now much more likely events: (1) sharply rising interest rates, and (2) widespread credit losses. Thus, each good year reported is a lot like the year when a Texas hurricane insurer reports satisfactory earnings because there have been no hurricanes. Mutual Savings has a considerable share of this uncomfortable position and will continue to have it. It has not yet developed a long-term operating strategy with which it is satisfied, and it continues to seek one. Just as Mutual Savings has been idiosyncratic in the past as it sold branch offices in 1980 (a practice now being adopted to some extent by other savings and loan associations and major banks), it will probably be idiosyncratic in the future. It will seek some non-standard way of rendering socially constructive service while operating with acceptable profits accompanied by an acceptable level of risk for shareholders' capital, likely gains considered.

Eventually, by maintaining unusual capital strength and liquidity, and by having a parent corporation which does likewise, Mutual Savings hopes to stand in particular favor with federal and state regulatory authorities and be in a position soundly to expand again, perhaps dramatically, and perhaps involving additional shareholder investment in Mutual Savings by the parent corporation.

As part of a program for the anticipated eventual sound expansion of the savings and loan business, Mutual Savings in 1983, without heavy promotion or advertising, consistently paid about ½% per annum more than most competitors on so-called "money market rate accounts" of moderate size. This type of savings account is repayable on demand without penalty and allows up to three withdrawals by check each month. Most of Mutual Savings' "money market rate accounts" are in the range of $10,000 to $100,000. Mutual Savings' practice of bidding up slightly for this one type of account penalized 1983 earnings to a small extent and caused the bulk of the reported $36 million growth in savings.

Precision Steel

Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, was acquired for approximately $15 million on February 28, 1979. The price was roughly book value for a company which carried its inventories on a conservative LIFO accounting basis and which contained significant cash balances. More important, it had reached its position from a modest beginning through maintenance of sound, customer-oriented business values inculcated over a long time by a gifted founder and his successors. Precision Steel owns a well-established steel service center business and a subsidiary engaged in the manufacture and distribution of tool room supplies and other specialty metal products.

Precision Steel's businesses contributed $1,622,000 to ordinary net operating income in 1983, up 396% compared with $327,000 in 1982. Most of the increase was caused by (1) generally improved conditions in the cold-rolled strip steel market, and (2) absence in 1983 of an unusual loss which occurred in 1982 from correction of a business mistake (in which the present chairman of Wesco personally participated), namely a venture in the measuring tool distribution business which with better judgment would not have been authorized.

Under the leadership of David Hillstrom, Precision Steel's businesses are now satisfactory, taking into account the financial leverage put into Wesco's consolidated picture incident to their acquisition. The improvement from disappointing performance in 1982 is welcome. No dramatic change is expected in 1984 in either direction.

Shortly after Wesco's purchase of Precision Steel, a substantial physical expansion of steel warehousing facilities was authorized, involving a new building in Charlotte, North Carolina. The new building and the whole North Carolina operation are now successful, contributing $7,605,000 to sales in 1983 at a profit percentage higher than has prevailed in the long-established Chicago headquarters' facility.

Precision Steel's businesses, despite their mundane nomenclature, are steps advanced on the quality scale from mere commodity-type businesses. Many customers of Precision Steel, needing dependable supply on short notice of specialized grades of high-quality, cold-rolled strip steel, reasonable prices, technical excellence in cutting to order, and remembrance when supplies are short, rightly believe that they have no fully comparable alternative in Precision Steel's market area. Indeed, many customers at locations remote from Chicago and Charlotte (for instance, Los Angeles) seek out Precision Steel's service.

Wesco remains interested in logical expansion of Precision Steel's businesses, using liquid assets available.

All Other Ordinary Net Operating Income

All other ordinary net operating income, net of interest paid and general corporate expenses, rose to $3,839,000 in 1983 from $3,412,000 in 1982. Sources were rents ($2,609,000 gross, including rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant) and interest and dividends from cash equivalents and marketable securities held by Precision Steel and its subsidiaries and at the parent company level.

Net Gains on Sales of Securities, Mortgages and Important Fixed Assets

Wesco's aggregate special net gains, combined, after income taxes, declined to $2,046,000 in 1983 from $4,281,000 in 1982. The 1982 net gain consisted of $6,706,000 from sales of securities, offset by a loss of $2,425,000 from Mutual Savings' sales of mortgage-backed securities. There were no losses from sales of mortgages or mortgage-backed securities in 1983.

Consolidated Balance Sheet and Related Discussion

Wesco's consolidated balance sheet retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others. As indicated in Note 2 to the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate cost at December 31, 1983 by about $29 million. In addition, Wesco's Pasadena office building block (containing about 155,000 net rentable square feet including Mutual Savings' space) has a market value substantially in excess of carrying value. The mortgage debt ($5,166,000 at 9.25% fixed) against this real property now exceeds its depreciated carrying value ($3,077,000) in Wesco's balance sheet at December 31, 1983. Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity, however, requires some patience, as suitable opportunities are not always present.

As indicated in Schedule I accompanying Wesco's financial statements, common stock investments, both those in the savings and loan subsidiary and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in a very few companies. Through this concentration practice better understanding is sought with respect to the few decisions made.

The ratio of Wesco's annual consolidated net income to consolidated shareholders' equity, about 9% in 1982-83, is not yet attractive from the Wesco shareholders' point of view. Wesco, started as a savings and loan holding company in what became a very tough business, has been proceeding slowly under shortened sail instead of trying to make fast time by getting all canvas aloft. However, progress ultimately helpful to shareholders is not restricted to what shows up in the income account. Recent increases in balance sheet strength are expected to be useful in the future.

On January 26, 1984, Wesco increased its regular quarterly dividend from 13½ cents per share to 14½ cents per share, payable March 7, 1984 to shareholders of record as of the close of business on February 14, 1984.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. We invite your careful attention to these items.

Retirement of Louis Vincenti

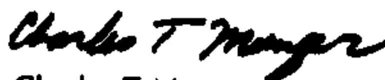
Late in 1983 Louis Vincenti retired from Wesco on account of health. He had served 28 years, the last 10 years as Chief Executive Officer. Before joining Wesco, as a partner in Hahn and Hahn, he was one of Southern California's great attorneys. Before practicing law he had starred spectacularly as both student and athlete at Stanford.

Wesco had a net worth of about $5 million when he joined it in 1955. As he retires the net worth of Wesco is about $124 million, and, in addition, cash dividends of about $26 million have been paid out to shareholders over the years. The consolidated enterprise first made extraordinary profits as a construction lender, then went through the 1981-82 crisis period in the savings and loan industry reporting steady profits, paying dividends which increased each year, and piling up more capital outside the troubled savings and loan business as a start was made at diversifying sources of operating income.

The entire record was accompanied by much philanthropic and public service and service to the savings and loan industry by Mr. Vincenti. All who know him admire him, in whom generosity, acuity, diligence and a totally forthright manner are so happily joined. In a career of extraordinary length as well as distinction, he came to work before 7:30 each morning until very shortly before he retired at age 77.

There are not many men in the world like Louis Vincenti. Wesco has been a very fortunate corporation to be guided so long by such a man.

Mr. Vincenti's colleagues who replaced him are Charles T. Munger as Chairman and Chief Executive Officer of Wesco and Mutual Savings and Harold R. Dettmann as President of Mutual Savings. Mr. Munger also is Vice Chairman of Berkshire Hathaway Inc., 80%-owner of Wesco. Mr. Dettmann for many years served as operating manager next in line to Mr. Vincenti.



Charles T. Munger
Chairman of the Board

February 3, 1984

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WESCO FINANCIAL CORPORATION

Annual Report 1984

Form 10-K Annual Report 1984

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" operating income (i.e., before all unusual operating income and all net gains from sales of securities) for the calendar year 1984 increased to $10,060,000 ($1.42 per share) from $8,507,000 ($1.20 per share) in the previous year.

Consolidated net income (i.e., after unusual operating income and all net gains from sales of securities), increased to $23,656,000 ($3.32 per share) from $10,553,000 ($1.48 per share) in the previous year.

Despite the high numbers reported, 1984 was a so-so year in terms of real gain in strength. While "normal" net operating income increased satisfactorily, total net income was swollen in a major way only because of an unusual item of operating income and the cashing in of some unrealized appreciation in marketable securities which had occurred in earlier years.

Wesco has two major subsidiaries, Mutual Savings, in Pasadena, and Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	"Normal" Net Operating Income of					
	Mutual Savings	Precision Steel Businesses	All Other "Normal" Net Operating Income(2)	Gain from Unrealized Appreciation in Forward Commitment of Mutual Savings to Buy GNMA Certificates	Net Gains on Sales of Securities(3)	Wesco Consolidated Net Income
December 31, 1984 .	$3,476	$2,034	$4,550	$458	$13,138	$23,656
Per Wesco share . .	.49	.29	.64	.06	1.84	3.32
December 31, 1983 .	3,046	1,622	3,839	—	2,046	10,553
Per Wesco share . .	.43	.23	.54	—	28	1.48

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings' headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan subsidiary.

(3) Includes $1,080,000 ($.15 per share), which, under different accounting treatment, might have been both (1) shifted to a different income category and (2) increased by $1,765,000 ($.25 per share). See "Unusual Income and Certain Accounting Quirks in 1984 Reporting" below.

The foregoing breakdown (of the same aggregate earnings) differs somewhat from that used in audited financial statements, which follow standard accounting convention as interpreted from time to time by Wesco's outside auditor. The supplementary breakdown of earnings is furnished because it is considered useful to shareholders.

Much of this letter is a word-for-word repeat of last year's letter with updated numbers. The repetition of wording occurs because it is believed (1) that the duplicated material remains correct and is worth repeating, and (2) that in Wesco's case any time and money required to change wording would be better spent elsewhere.

Parsimony, however, does not wholly predominate. So much kidding occurred concerning the 1960s automobiles in the old photograph of the Mutual Savings' building, which was used in last year's annual report to avoid incurring the cost of a new photograph, that the purse has been opened a little. Shareholders comparing the new photograph (on the inside front cover of this report) with the old will note that the trees have grown a lot in the intervening years. Fortunately, so has the value of the building. See the last section of this letter. The building, which works very well and attracts high quality tenants regarded as friends, is a constant reminder of the good sense of Louis R. Vincenti and Richard D. Aston, the Wesco executives responsible for its creation.

Mutual Savings

Mutual Savings' "normal" net operating income of $3,476,000 in 1984, represented an increase of 14.1% from the $3,046,000 figure the previous year. In both years such "normal" net operating income, while economically real and probably of at least average quality as reported savings and loan industry incomes go, was below the top quality possible because such earnings came entirely or partly from income tax savings obtained through inclusion of Mutual Savings in the consolidated income tax return of a parent corporation. Earnings so derived from income tax savings are not of the top quality possible because they can be impaired by future changes in tax laws and have less cushion in reserve against future adversity than earnings from ordinary operating income on which income taxes have been paid in full in cash at the highest corporate rate and are recoverable from the I.R.S. in the event of future operating losses.

Separate balance sheets of Mutual Savings at yearend 1983 and 1984 are set forth at the end of this annual report. They show (1) total savings accounts rising to $228 million from $203 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (probably the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, and (4) a loan portfolio (mostly real estate mortgages) of about $95 million at the end of 1984, down 11% from the $107 million at the end of 1983. The loan portfolio at the end of 1984 bore a fixed average interest rate of only 7.63%, probably the lowest for any U.S. savings and loan association and far below the average interest rate which now must be paid to hold savings accounts.

The capital-rich, mortgage-loan-interest-rate-poor position of Mutual Savings came from (1) success many years ago as a construction lender at above-average interest rates, plus (2) sale in 1980 by Mutual Savings of all branch offices (except for one satellite office in a major shopping center across the street from the Pasadena headquarters) under terms where only the lowest-yielding mortgage loans from its large portfolio were retained, plus (3) drastic curtailment by Mutual Savings of mortgage lending following the sale of its branch offices, plus (4) profits in every recent year, no matter how high interest rates went.

Mutual Savings has remained profitable because the adverse effects from its old low yielding, fixed-rate mortgage loan portfolio are more than offset by favorable effects from its large shareholders' equity and a tax-equivalent yield on its marketable securities (utility preferred stocks, tax-exempt bonds and common stocks) considerably higher than that prevailing on the mortgage loan portfolio of a typical savings and loan association. The old low-yielding, fixed-rate mortgage loan portfolio has shrunk from pay-backs at 9.8% per year over the last three years, and the shrinkage is expected to

continue at about the same rate. With portfolio shrinkage, loan credit quality problems have been reduced to a meaningless trace, because the old mortgages have large real estate equities supporting secured credit extended. And the foreclosed property on hand (mostly 22 vacant, largely oceanfront, acres in Santa Barbara) over a long holding period has plainly become worth considerably more than its $2 million balance sheet carrying cost.

It should be noted, however, that Mutual Savings' total mortgage loan portfolio did not, in substance as distinguished from accounting form, decrease in 1984 by the 11% mentioned above, determined by comparing audited year end balance sheet totals for loans. Mutual Savings has agreed to buy in 1986 U.S. Government guaranteed mortgage equivalents (GNMA certificates) at a price of about $19 million and has pre-funded this forward commitment by buying U.S. Treasury Notes maturing near the time the certificates will be purchased. After taking into account this forward commitment to purchase GNMA certificates, Mutual Savings' total mortgage loan portfolio has, in substance, *increased* by about 7% in 1984.

The 1984 increase in substance of mortgages owned reflects Mutual Savings' intention to keep at least 60% of assets in mortgages or mortgage equivalents, exactly as the Federal Home Loan Bank Board wisely exhorts the savings and loan industry to do if it expects to remain under a regulatory system separate from that of banks. And as a result of anticipated steady shrinkage through repayment of remaining old 7.63% mortgages, combined with purchases of new mortgages or mortgage equivalents bearing much higher interest rates, Mutual Savings expects in due course significantly to raise the average rate of interest on the entire mortgage loan portfolio, thus improving earnings so long as interest rates on savings accounts do not greatly increase. The GNMA certificates purchased for 1986 delivery at a price of about $19 million are expected to yield about 15% on such price, getting under way the process of "blending" the mortgage loan portfolio yield to a higher average level.

Mutual Savings has adapted in its own way to the dramatic changes which have occurred in recent years in interest rates and the regulatory structure of the banking and savings and loan industries. At Mutual Savings, as well as the rest of the savings and loan industry, the standard practice used to be to borrow short from savers while lending long on fixed-rate mortgages, to have high financial leverage for shareholders' equity and to grant mortgagors easy prepayment terms. The practice was profitable for decades but always involved something like a "hurricane risk," and the equivalent of a hurricane came in 1981-82 as interest rates rose to unprecedented levels and caused widespread losses. Results were good for shareholders before 1981-82 only because interest rates were stable or rose slowly as mortgage-loan portfolios steadily and rapidly expanded under a regulatory structure which both fostered growth and protected operating margins by requiring that on all insured savings accounts fixed rates be paid that were slightly higher than the low rates specified for banks. Thus a small deposit-attracting rate advantage over banks was given to savings and loan associations, while competitive pressure was dampened for both types of institution.

Although interest rates have subsided from the 1981-82 peak, the low and slowly changing interest rates of former years are plainly gone with the wind, as are the former government-decreed limits on interest rate competition for savings accounts and the favoritism for savings and loan associations over banks. But an agency of the U.S. Government (FSLIC) continues to insure savings accounts in the savings and loan

industry, just as it did before. The result may well be bolder and bolder conduct by many savings and loan associations. A sort of Gresham's law ("bad loan practice drives out good") may take effect for fully competitive but deposit-insured institutions, through increased copying by cautious institutions of whatever apparent-high-yield loan and investment strategies seem to allow competitors to bid away their savings accounts and yet report substantial earnings. If so, if "bold conduct drives out conservative conduct," there eventually could be widespread insolvencies caused by bold credit extensions come to grief.

And if serious credit-quality troubles come to the savings and loan industry, they will merely add to troubles from the borrowed-short, lent-long-at-fixed-rates problem, which is far from completely removed, and which destroys shareholder wealth at startling speed whenever interest rates are rising rapidly, even when the credit quality of mortgagors or other borrowers is excellent.

The Federal Home Loan Bank Board, under its current Chairman Edwin R. Gray, shares Wesco's concerns. Wesco approves its attempts by regulation and by "jawboning" to limit follies to come from (1) sharing the U.S. Government's credit with optimistic new entrants to the savings and loan business, often coming from the real estate development and stock brokerage businesses, given ample scope to venture under widened investment authority, and (2) high financial leverage throughout the savings and loan industry, combined with continuing maturity mismatch of fixed rate assets and liabilities. Logic and history would suggest that Mr. Gray is right to pull on the reins, but this is an unpopular task since many powerful activity-cravers feel the bit and create political heat in opposition to even limited (and almost surely inadequate) financial discipline which would protect the federal deposit-insurance system by demanding a significant margin-of-safety factor in financial institutions, just as in bridges. Wesco is not optimistic either that the present rules of the savings and loan game will stand the test of time or that drastic changes in the rules will occur until huge future trouble comes, sooner or later.

Developing a short-term operating plan for Mutual Savings which would sharply increase its reported earnings next year would be a near-absolute cinch. For instance, savings accounts could be expanded greatly by paying a high rate of interest on "jumbo" deposits in $100,000 multiples, and proceeds plus cash equivalents on hand could be placed in long-term mortgages at a substantial current interest spread while, in addition, some origination fees could be "front-ended" into income. However, taking long-term risks into account, it is much harder to find a sound operating plan. Money is the ultimate fungible commodity. In the new order of things, an association is not only in a tough, competitive, commodity-type business on the lending side but also finds that, with decontrol of government-insured rates paid savers, every competitive association has virtually unlimited credit to fund increased lending, by paying premiums over interest rates generally prevailing on savings accounts. Under such conditions when all risks are considered, including those created by that portion of competitors motivated primarily by short-term effects, it is quite naturally difficult to earn over a long period an attractive return on shareholders' equity. How could it be otherwise?

A few years ago, about the time Mutual Savings reacted to new conditions by curtailing lending and financial leverage, most other associations decided instead to keep lending aggressively but under new adjustable-rate mortgages under which some portion (but far from all) of the interest-rate-fluctuation risk is shifted to the homeowner.

Despite widespread use of these new adjustable-rate mortgages, savings and loan industry earnings remain dependent to a material extent, as they always were, on an interest rate spread attributable to: (1) borrowing short while lending long, and/or (2) making loans which can be priced high enough to provide a profit only because they involve a very material credit risk, compared to the risk of owning government-backed securities of comparable maturity.

Under present conditions of strong competition from bold competitors accompanied by high interest-rate-fluctuation risk, the result tends to be that each year of reported attractive earnings in the savings and loan industry occurs only in the absence of two now much more likely events: (1) sharply rising interest rates, and (2) widespread credit losses. Thus, each good year reported is a lot like the year when a Texas hurricane insurer reports satisfactory earnings because there have been no hurricanes. Mutual Savings has a considerable share of this uncomfortable position and will continue to have it. It has not yet developed a long-term operating strategy with which it is satisfied, and it continues to seek one. Just as Mutual Savings has been idiosyncratic in the past as it sold branch offices in 1980 (a practice since adopted to some extent by other savings and loan associations and major banks), it will probably be idiosyncratic in the future. It will seek some non-standard way of rendering socially constructive service while operating with acceptable profits accompanied by an acceptable level of risk for shareholders' capital, likely gains considered.

Eventually, by maintaining unusual capital strength and liquidity, and by having a parent corporation which does likewise, Mutual Savings hopes to stand in particular favor with federal and state regulatory authorities and be in a position soundly to expand again, perhaps dramatically, and perhaps involving additional shareholder investment in Mutual Savings by the parent corporation.

Recent growth in savings accounts, considered on an incremental-effects basis, constitutes loss business, because Mutual Savings has incurred in interest and other expense more than it has received from employing proceeds in short-term interest-bearing investments far above regulatory requirements for liquidity. Moreover, some of the attendant expense may not have hit the books. In due course (starting in 1985) Mutual Savings, which with its large ratio of shareholders' equity to total liabilities imposes a virtually zero risk on FSLIC (the U.S. agency which insures safety of accounts in savings and loan associations), will be required to pay to FSLIC extra insurance premiums, based on Mutual Savings' gross size, to help fund FSLIC's protection of account holders in other savings and loan associations finally recognized as insolvent. In this process Mutual Savings, in effect, will retroactively pay extra interest-equivalent expense by reason of having attracted new savings. Mutual Savings' position at the moment is like that of a sober and careful automobile driver of 2000 miles per year, disadvantaged by his limited activity, yet forced to pay mutualized, standardized insurance premiums so long as he lives based on inclusion in a liability insurance pool (1) which is composed almost entirely of much worse risks, (2) which contains a considerable number of traveling salesmen previously convicted of drunk driving, and (3) which discovers liabilities, partly through institutional design, long after their occurrence. Deliberate growth in savings, under such conditions, reflects considerable optimism, perhaps Micawberish, that Mutual Savings will eventually have better ideas and opportunities and that its officers (including the Chairman) will make fewer of the sort of mistakes in which they participated in the past, leading to difficulties now decried.

The foregoing comments, designed to communicate reality for Wesco shareholders as it appears to Wesco management, should not be taken as criticism of FSLIC management. In recent years FSLIC management has bordered on heroic, considering economic and legal changes, political pressures, extraordinary work burden, novel problems and limited resources.

Precision Steel

Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, was acquired for approximately $15 million on February 28, 1979. The price was roughly book value for a company which carried its inventories on a conservative LIFO accounting basis and which contained significant cash balances. More important, it had reached its position from a modest beginning through maintenance of sound, customer-oriented business values inculcated over a long time by a gifted founder and his successors. Precision Steel owns a well-established steel service center business and a subsidiary engaged in the manufacture and distribution of tool room supplies and other specialty metal products.

Precision Steel's businesses contributed $2,034,000 to "normal" net operating income in 1984, up 25% compared with $1,622,000 in 1983. Such a sharp increase in 1984 profit was not anticipated and was largely attributable to (1) increased sales (up 20% to $55,098,000) and (2) some favorable quantity-order prices on steel purchased.

Under the leadership of David Hillstrom, Precision Steel's businesses are now quite satisfactory, taking into account the financial leverage put into Wesco's consolidated picture incident to their acquisition. The 1984 year could be a hard act to follow.

Shortly after Wesco's purchase of Precision Steel, a substantial physical expansion of steel warehousing facilities was authorized, involving a new building in Charlotte, North Carolina. The new building and the whole North Carolina operation are now very successful, contributing $8,589,000 to sales in 1984 at a profit percentage higher than has prevailed in the long-established Chicago headquarters' facility.

Precision Steel's businesses, despite their mundane nomenclature, are steps advanced on the quality scale from mere commodity-type businesses. Many customers of Precision Steel, needing dependable supply on short notice of specialized grades of high-quality, cold-rolled strip steel, reasonable prices, technical excellence in cutting to order, and remembrance when supplies are short, rightly believe that they have no fully comparable alternative in Precision Steel's market area. Indeed, many customers at locations remote from Chicago and Charlotte (for instance, Los Angeles) seek out Precision Steel's service.

Wesco remains interested in logical expansion of Precision Steel's businesses, using liquid assets available.

All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, rose to $4,550,000 in 1984 from $3,839,000 in 1983. Sources were (1) rents ($2,078,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant) and (2) interest and dividends from cash equivalents and

marketable securities held by Precision Steel and its subsidiaries and at the parent company level.

Net Gains on Sales of Securities

Wesco's aggregate net gains on sales of securities, combined, after income taxes, increased to $13,138,000 in 1984 from $2,046,000 in 1983. The large 1984 gains do not indicate special acumen or good fortune in 1984. It merely happened that in 1984 unrealized appreciation occurring in previous years was cashed in.

A $1,080,000 portion of 1984 securities gains, if a different accounting treatment had been used, would have been both: (1) shifted to a different income category and (2) increased by $1,765,000. See next section.

Unusual Income and Certain Accounting Quirks in 1984 Reporting

Wesco's consolidated audited figures for net earnings contained in this Annual Report are lower by $1,328,000 in aggregate ($.19 per share) with respect to the nine months ended September 30, 1984, than the figures contained in Wesco's previously-issued quarterly reports covering such nine months.

The downward restatement of earlier reported earnings occurred because, after the close of the year, Wesco's outside auditor made an unanticipated interpretation of generally accepted accounting principles applicable to an unusual business transaction.

The unusual business transaction was cash paid by General Foods for transfer of General Foods' stock from Wesco to General Foods under a written arrangement with General Foods, specifying intention to create an exact dividend-equivalent, which kept Wesco's percentage ownership of General Foods the same at all times. Under such circumstances, income tax law quite naturally treats all proceeds of the in-form "sale" of General Foods stock as a dividend, which is the I.R.S. view as well as Wesco's view of the underlying economic substance. Last year, in a virtually identical case, Wesco's outside auditor approved, for the consolidated group of which Wesco is a part, financial statements including accounting treatment in conformity with in-substance dividend reporting to the I.R.S. and Wesco's 1984 quarterly reports of earnings followed this precedent with no objection. But, after much deliberation, the outside auditor's opinion early in 1985 came down in favor of treating the 1984 transactions with General Foods as sales instead of dividend-equivalents, except that income tax provision continued to be computed on the in-substance dividend basis.

From the Wesco shareholders' vantage point the result from the outside auditing decision made is that the error, if any, existing in the audited accounts by reason of the Wesco-auditor disagreement is now on the side of underreporting income. Wesco's audited net income for the full year 1984 is now lower by $1,765,000 ($.25 per share) than would have been reported if all proceeds of the 1984 business transaction with General Foods had been reported as unusual dividends or dividend-equivalents, following Wesco's view of substance. Either way, any income from the Wesco-General Foods business transaction is reported as "unusual" or from an irregular source (securities gains), and, either way, the 1984 year end balance sheet is exactly the same, except that in one case (Wesco's view) the after-tax balance sheet carrying cost would have been $1,765,000 higher for an identical number of General Foods' shares owned, with the $1,765,000 increase augmenting book net worth of Wesco.

While Wesco disagrees with its outside auditor on the accounting issue, Wesco can find something to applaud in (1) a de-emphasis of year-to-year consistency in search for an answer best in the auditor's latest view and (2) an auditor's favoring of a decision, where it has any doubt, which may err on the side of under-reporting income, considering a common tendency of corporate clients to favor decisions in the opposite direction.

Were Wesco running a national accounting partnership it would want a system where a high-ranked partner, free of business-retaining pressure, could reverse accounting decisions urged by field partners, so Wesco can hardly complain about the inconsistent messages from an audit-management system which forced Wesco in 1984 to change at year end quarterly income figures earlier reported. However, in this murky case, where we happen to know that one of the country's most eminent accountants agrees with the Wesco view, we must admit to minor irritation with the fates. Wesco makes special effort aimed at high-quality reporting to shareholders. (For instance, only with respect to competitively proprietary information, such as transactions in marketable securities, does Wesco consciously keep communication with shareholders to the legal minimum.) Thus when the audit quality-control system of its outside C.P.A. firm selects Wesco for forced restatement of numbers previously given shareholders, we feel much as if we were a duty-obsessed engineering student at Brigham Young University, accidentally tear-gassed by the national guard in a necessary program to control campus unrest.

The subject of this restatement of a small part of Wesco's earnings is covered at length here only because, much more often than not, it is a bad sign for shareholders when a full year-end audit decreases income reported as earned in previous quarterly reports. A full explanation is therefore appropriate.

The inconsistency between quarterly and final income figures is not the only accounting quirk in Wesco's audited 1984 financial statements. It seems odd, as highlighted above in the unconventional breakdown of earnings, that unrealized appreciation of $458,000 in a forward commitment to buy mortgage-equivalents was taken into Mutual Savings' income in 1984, which happened because the commitment was made in a futures market on a commodities exchange. A forward commitment to buy the same mortgage equivalents, made in some other manner, for instance by simple contract, would not, under the applicable accounting rules, result in the same unrealized appreciation's being reported as income. And, even though the unrealized appreciation is recognized as income in the 1984 earnings statement, shareholders must look deep into a footnote to the audited 1984 financial statements to find the only reference to the mortgage equivalents which produced the appreciation. The balance sheet standing alone discloses only short-term investments (U.S. Treasury Notes in this instance) the proceeds of which will be used in 1986 to close the forward commitment to buy the mortgage equivalents.

It also seems odd, in view of the substantial additional costs FSLIC membership will in the near future impose on Mutual Savings, that prepaid FSLIC premiums amounting to $3,146,000 are included in the audited consolidated balance sheet, without offset for anticipated new cost of sharing FSLIC liabilities. We do not object to the accounting convention at work. All complexities and interests considered, the accounting profession is doing all right by the civilization; the FSLIC relationship has long been a valuable asset in the savings and loan industry, with its mutualized nature of no practical adverse consequence; and both accounting and public-policy considerations disfavor quick invention of new accounting convention to anticipate in current financial statements future increases in burden from FSLIC membership by reason of facts already known.

But quirks (at least as diagnosed by Wesco) required (probably wisely, on balance) by accounting convention, do contribute to causing Wesco to break down and discuss its earnings unconventionally in its management letter and also to call shareholders' attention to audit footnotes. The use of both footnotes and letter is needed for a best-feasible understanding of economic reality as it appears to Wesco management.

It is recognized, of course, by most certified public accountants as well as by Wesco that audited statements alone, unless accompanied by a letter giving management's view of economic reality where inconsistent with the image created by accounting convention, is an improperly incomplete form of annual communication with corporate owners. There is a limit to the communication which properly standardized accounting can create, and Wesco's outside auditors (and its parent companies' auditors) over the years have been quite supportive of Wesco's approach to expanding numerate communication in the management letter, even though outside auditing jurisdiction.

Written arrangements creating the issue of unusual dividend-equivalent income, of the type which caused reporting quirks in 1984 as a result of transactions with General Foods, can hardly be expected to be made year after year. However, Wesco does anticipate, based on an agreement already signed, that in 1985 more of the same sort of transactions will occur with General Foods, probably somewhat smaller in aggregate amount than in 1984.

Consolidated Balance Sheet and Related Discussion

Wesco's consolidated balance sheet (1) retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others and (2) reflects a continuing failure to acquire additional businesses because none are found available, despite constant search, at prices deemed rational when the interest of Wesco shareholders is taken into account.

As indicated in Note 2 to the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate cost at December 31, 1984 by about $13 million, down sharply from about $29 million one year earlier.

Wesco's Pasadena office building block (containing about 165,000 net rentable square feet including Mutual Savings' space) has a market value substantially in excess of carrying value, demonstrated by (1) mortgage debt ($5,182,000 at 9.25% fixed) against this real property now exceeding its depreciated carrying value ($3,069,000) in Wesco's balance sheet at December 31, 1984, and (2) substantial current net cash flow to Wesco after debt service on the mortgage.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities.

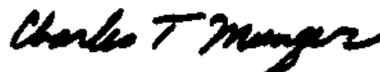
It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity, however, requires some patience, as suitable opportunities are not always present.

As indicated in Schedule I accompanying Wesco's financial statements, common stock investments, both those in the savings and loan subsidiary and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in a very few companies. Through this concentration practice better understanding is sought with respect to the few decisions made.

The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 13% in 1982-84, (1) was dependent to a considerable extent on securities gains, irregular by nature, and (2) nonetheless leaves something to be desired from the Wesco shareholders' point of view. Wesco began life as a savings and loan holding company in what became a very tough industry in which the real value, as distinguished from the reported book value, of most shareholders' equity became impaired, particularly in 1981-82. Damaged along with the rest of its industry, Wesco has been proceeding slowly under shortened sail, while it assesses damage and repairs the ship, instead of trying to make fast time by getting all canvas aloft. However, progress ultimately helpful to shareholders has not been restricted to what has shown up neatly in the income account covering this period. Increases over recent years in both (1) aggregate reported shareholders' equity and (2) the percentage of such equity outside Wesco's savings and loan segment are expected to be useful in the future.

On January 24, 1985, Wesco increased its regular quarterly dividend from 14½ cents per share to 15½ cents per share, payable March 7, 1985 to shareholders of record as of the close of business on February 19, 1985.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.



Charles T. Munger
Chairman of the Board

February 12, 1985

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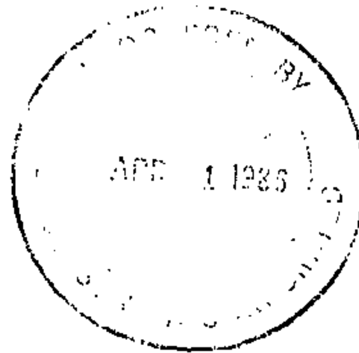
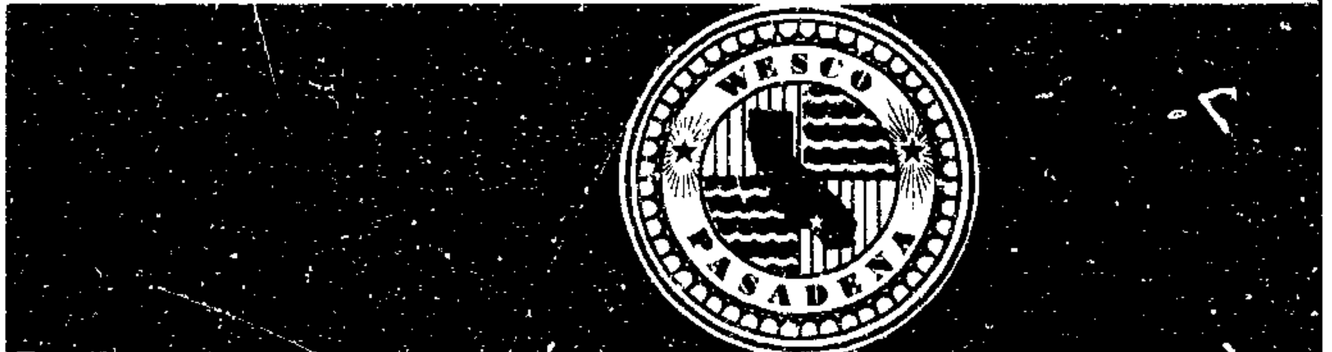




WESCO FINANCIAL CORPORATION

Annual Report 1985

Form 10-K Annual Report 1985

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" operating income (i.e., before all unusual operating income and all net gains from sales of securities) for the calendar year 1985 decreased to $8,347,000 ($1.17 per share) from $10,060,000 ($1.42 per share) in the previous year.

Consolidated net income (i.e., after unusual operating income and all net gains from sales of securities) increased to $51,541,000 ($7.24 per share) from $23,656,000 ($3.32 per share) in the previous year.

A highly unusual capital gain, of a not-likely-to-recur type, from disposition of General Foods stock caused most of the net income in 1985. The table below gives particulars.

Wesco has three major subsidiaries, Mutual Savings, in Pasadena, Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses, and Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged in the reinsurance business. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended			
	December 31, 1985		December 31, 1984	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income (loss) of:				
Mutual Savings	$ 3,342	$ .47	$ 3,476	$ .49
Precision Steel businesses	2,010	.28	2,034	.29
Wesco-Financial insurance business —				
Underwriting	(1,584)	(.22)	—	—
Investment activity	1,225	.17		
	(359)	(.05)		
All other "normal" net operating income[2]	3,354	.47	4,550	.64
	8,347	1.17	10,060	1.42
Fluctuation in market value of GNMA futures contract	1,671	.24	458	.06
Net gains on sales of securities[3]	41,523	5.83	13,138	1.84
Wesco consolidated net income	$51,541	$7.24	$23,656	$3.32

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries.

(3) The 1985 figure includes a $34,363,000 ($4.83 per share) gain realized by Wesco on the sale of its General Foods Corporation common stock to Philip Morris Company in connection with the latter's publicly announced tender offer. See "Net Gains on Sales of Securities" below.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

Mutual Savings

Mutual Savings' "normal" net operating income of $3,342,000 in 1985 represented a decrease of 4% from the $3,476,000 figure the previous year.

Separate balance sheets of Mutual Savings at yearend 1984 and 1985 are set forth at the end of this annual report. They show (1) total savings accounts rising to $269 million from $228 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (probably the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, (4) a loan portfolio (mostly real estate mortgages) of about $83 million at the end of 1985, down 12% from the $95 million at the end of 1984, and (5) favorable effects of securities gains and other unusual gains and fluctuations, which caused net worth to decline only $4 million in 1985 despite payment of a dividend of $14 million to the parent corporation.

The loan portfolio at the end of 1985, although containing almost no risk of loss from defaults, bore a fixed average interest rate of only 7.60%, probably the lowest for any U.S. savings and loan association and far below the average interest rate which now must be paid to hold savings accounts. However, as the loan payoff pace intensified and interest rates declined sharply in 1985, the unrealized depreciation in the loan portfolio became approximately offset by unrealized appreciation in Mutual Savings' interest-bearing securities and preferred stocks.

As pointed out in footnote 13 to the accompanying financial statements, the book value of Wesco's equity in Mutual Savings ($57.6 million at December 31, 1985) overstates the amount realizable, after taxes, from sale or liquidation at book value. If all Mutual Savings' assets, net of liabilities, were to be sold, even pursuant to a plan of complete liquidation, for the $57.6 million in book value reported under applicable accounting convention, the parent corporation would receive much less than $57.6 million after substantial income taxation imposed because about $47 million of what is designated shareholders' equity for accounting purposes is considered bad debt reserves for most tax purposes.

There is, however, a buried plus value in Mutual Savings. The foreclosed property on hand (mostly 22 largely oceanfront acres in Santa Barbara) has become worth over a long holding period much more than its $1.5 million balance sheet carrying cost. Reasonable, community-sensitive development of this property has been delayed over 10 years in the course of administration of land-use laws. But we are optimistic that an end to the delay is near and that the Santa Barbara and Montecito communities will be very pleased with the development now likely to go forward. This development will contain 32 houses interspersed with large open areas. Mutual Savings plans to make the development first rate in every respect, and unique in the quality of its landscaping.

Balancing all merits and demerits, Mutual Savings, as it has been managed under present conditions by the writer and others, is no jewel of a business from the shareholders' point of view. Mutual Savings' good points are: (1) high asset quality and sound balance sheet; (2) a maturity match of interest-bearing assets and liabilities which makes risk of insolvency near zero, whatever happens to interest rates; and (3) a deserved reputation for high quality service to account holders, achieved at below-average cost to the institution in an efficient one-large-office operation, as distinguished from a

many-small-branch-offices operation. Mutual Savings' bad points are: (1) all recent growth in savings accounts, considered on an incremental effects basis, has been loss business because interest and other costs incurred exceed income obtained by employing proceeds in short-term interest-bearing assets; (2) a burdensome position under the FSLIC account-insurance system causes payments of ever-higher amounts into the system to help bail out more venturesome savings and loan associations which become insolvent, with the payments being required despite the fact that Mutual Savings imposes almost no risk on FSLIC; (3) "normal" net operating income is below an acceptable rate of return on present book value of shareholders' equity, with such return reaching an acceptable level over recent years only with help from securities gains and other unusual items; (4) it would not be easy to leave the savings and loan business, should this course of action ever be desired, without a large income tax burden of a type not applied to corporations other than savings and loan associations; (5) the regulatory structure of the savings and loan business creates a competitive situation in which it is hard to make respectable profits through careful operations; and (6) management has not yet found an acceptable remedy for any of the previously listed bad points, despite years of trying.

Moreover, comparisons of post-1984 financial results for Mutual Savings with results for many other and more typical savings and loan associations in California leave Mutual Savings looking inferior, to put it mildly. As interest rates went down these other associations, which have greater financial leverage and operated less fearfully than Mutual Savings during former high-interest periods, came to have loan and investment portfolios which (1) now are worth more on average than book value and (2) now produce a high return on book value of shareholders' equity, after deduction of operating expenses and interest to account holders at present rates. Any Wesco shareholder who thinks Mutual Savings has any expertise in predicting and profiting from interest rate changes can look at the 1985 record and despair.

Despite the fact that some other savings and loan associations did much better after 1984 than Mutual Savings, and are now much better poised to report good figures for 1986, we plan to continue operating only in ways acceptable in our own judgment, anticipating as a consequence widely fluctuating and sometimes inadequate returns. In the future, however, Mutual Savings will make and purchase more loans. Now that Mutual Savings' old mortgage loans have declined in amount and increased in market value (the market value increase being caused both by a decline in generally prevailing interest rates and by a shortening of remaining loan life), new loans will be added as seems wise, with a target that 60% of assets be in housing-related loans. The first new direct loan in some time, an adjustable rate mortgage with no cap on future interest rate changes but with an extremely low "spread" for the lender, will shortly be closed. We are not at all excited by our prospects as we now make housing loans of this type, but we wish to get some renewal of direct mortgage lending under way.

With assets not employed in direct real-estate lending, Mutual Savings continues not only to make payments to FSLIC far in excess of fair charges for risks imposed on FSLIC but also to employ a large part of total assets in short-term loans to the Federal Home Loan Bank. These practices are pro-social but will continue to reduce profits.

Mutual Savings also continues to support the Federal Home Loan Bank Board in its efforts to change the present rules of the savings and loan business to augment average

soundness of FSLIC-insured associations. We retain our opinion that the present rules, despite some improvement in 1985 through wise efforts of the Federal Home Loan Bank Board, are unsound, from the country's point of view. Too much latitude is allowed financial "swingers" to grow as they gamble, through use of account guarantees from FSLIC, an agency of the U.S. Government, while they offer whatever it takes in interest rates to attract more accounts.

With money being the ultimate fungible commodity, it seems to us that the rules create a super-competitive, commodity-type business, in which (1) economic law probably destines most careful associations, like other fungible-commodity dealers, to realize very modest returns on shareholders' equity over extended time periods, yet (2) good financial results can nonetheless usually be reported in each near-term period by managers-in-charge through aggressive deposit-expanding, lending and investing measures which increase risk, while (3) the importance and rewards of managers, who usually have little downside risk as owners, are tied mostly to institutional size and recently reported numbers. With managers mostly being non-owners, a sort of Gresham's law of competitive-yet-deposit-insured banking, "bad loans drive out good," tends to work with extra force as managers fear being left out of whatever activity allows competing managers to report high profits while bidding high for deposits. We see no reason for assuming that ethical, intelligent managers in the savings and loan industry are immune from effects similar to those which caused similar managers of all major U.S. banks to place significant portions of assets in now-regretted foreign loans, rather than stand apart from the crowd. If our diagnosis is correct, a lot of serious trouble lies ahead (perhaps far ahead) for U.S. savings and loan associations.

While present rules and practices have a positive side in causing satisfaction of almost 100% of demand for those housing loans which are sound at the prevailing interest rate, this accomplishment is accompanied by much unsound housing and other lending and by much unsound investment in "junk bonds" and other assets unsuitable for highly leveraged, federally insured, deposit-taking institutions. The system design in place would probably be a flunking design in an engineering course, where the emphasis would be on preserving the integrity of an essential system by a margin of safety, by being content with rules which (1) caused satisfaction of, say, only 95% of requests for sound credit extension and (2) forced more conservative conduct on banks and savings and loan associations.

The present design, we think, would probably also be a flunking design in a surgery course, where the wise practice is to remove some healthy cells along with cancerous cells, based on margin-of-safety principles. We hope we are wrong about the present design of the savings and loan system, but we fear increased, widespread adversity, ultimately reaching housing borrowers and would-be housing borrowers, whose interests we consider important. Any such adversity would probably be followed by changes in the rules. No doubt, our judgment as to the probable temporary nature of present savings and loan industry structure and practices has helped deter us from direct lending of a conventional sort which otherwise would have occurred. Our attitude, right or wrong, during recent tumultuous changes in the savings and loan industry, has been roughly that of the French grandfather who replied when asked what he did in the great revolution: "I got through." We also think something good could eventually happen to Mutual Savings because future trouble in the savings and loan business may create opportunities worth seizing.

Precision Steel

Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, was acquired for approximately $15 million on February 28, 1979. The price was roughly book value for a company which carried its inventories on a conservative LIFO accounting basis and which contained significant cash balances. More important, the company had reached its position from a modest beginning through maintenance of sound, customer-oriented business values inculcated over a long time by a gifted founder and his successors. Precision Steel owns a well-established steel service center business and a subsidiary engaged in the manufacture and distribution of tool room supplies and other specialty metal products.

Precision Steel's businesses contributed $2,010,000 to "normal" net operating income in 1985, down 1% compared with $2,034,000 in 1984. Such a modest decrease in 1985 profit was achieved in spite of decreased sales (down 7% to $51,124,000).

Under the skilled leadership of David Hillstrom, Precision Steel's businesses are now quite satisfactory, taking into account the financial leverage put into Wesco's consolidated picture incident to their acquisition.

Shortly after Wesco's purchase of Precision Steel, a substantial physical expansion of steel warehousing facilities was authorized, involving a new building in Charlotte, North Carolina. The new building and the whole North Carolina operation are now very successful, contributing $9,140,000 to 1985 sales at a profit margin higher than has prevailed in the long-established Chicago headquarters' facility.

Precision Steel's businesses, despite their mundane nomenclature, are steps advanced on the quality scale from mere commodity-type businesses. Many customers of Precision Steel, needing dependable supply on short notice of specialized grades of high-quality, cold-rolled strip steel, reasonable prices, technical excellence in cutting to order, and remembrance when supplies are short, rightly believe that they have no fully comparable alternative in Precision Steel's market area. Indeed, many customers at locations remote from Chicago and Charlotte (for instance, Los Angeles) seek out Precision Steel's service.

Wesco remains interested in logical expansion of Precision Steel's businesses, using available liquid assets.

Wesco-Financial Insurance Company

A new business was added to the Wesco group in 1985, in co-venture with Wesco's 80% owner and ultimate parent corporation, Berkshire Hathaway Inc.

With the enthusiastic approval of all Wesco's directors, including substantial Wesco shareholders in the Peters and Caspers families, without whose approval such action would not have been taken, Wesco invested $45,000,000 in cash equivalents in a newly organized, wholly owned, Nebraska-chartered insurance company, Wesco-Financial Insurance Company ("Wes FIC").

The new subsidiary Wes FIC, then reinsured, through another Berkshire Hathaway insurance company subsidiary as intermediary without profit, 2% of the entire book of insurance business of the long established Fireman's Fund Corp. (listed on the NYSE).

Wes-FIC thereby assumed the benefits and burdens of Fireman's Fund's prices, costs and losses under a contract covering all insurance premiums earned by Fireman's Fund during a four-year period commencing September 1, 1985. The arrangement puts Wes-FIC in almost exactly the position it would have been in if it, instead of Fireman's Fund, had directly written 2% of the business. Differences in results should occur only from the investment side of insurance, as Wes-FIC, instead of Fireman's Fund, invests funds from "float" generated. Wes-FIC's share of premiums earned in 1986 is expected to be over $60 million.

Wes-FIC's separate financial statements, covering the brief period of its existence, September 1, 1985, to December 31, 1985, are included on pages 29 and 30 of this Annual Report, and show that Wes-FIC experienced a small 1985 reduction in net worth, from $45,000,000 to $44,676,000.

We do not consider this four-month result to have significant predictive value with respect to the future. The price of insurance is rising, with price increases not yet fully reflected in 1985 numbers. Moreover, the financial statements are of questionable accuracy and could be wrong in either direction. It is in the nature of even the finest casualty insurance businesses that in keeping their accounts they must estimate and deduct all future costs and losses from premiums already earned. Uncertainties inherent in this undertaking make financial statements more mere "best honest guesses" than is typically the case with accounts of non-insurance-writing corporations. And the reinsurance portion of the casualty insurance business, because it contains one or more extra links in the loss-reporting chain, usually creates more accounting uncertainty than the non-reinsurance portion. Finally, Wes-FIC's initial financial statements have a disadvantage in that the period covered is short, making any use of the reported past cost-price ratio extra dubious as an indicator of any probable future cost-price ratio, due to the small size of the sample forming a base for projection.

It is entirely too soon to forecast future results for Wes-FIC, but Wesco hopes for: (1) a reasonable return on its investment over the four years of the Fireman's Fund reinsurance contract, and (2) possible future reinsurance contracts with other insurers.

Wesco has high regard for John Byrne, newly appointed CEO and also a large shareholder and stock-option holder of Fireman's Fund. Mr. Byrne was an outstanding insurance company manager in his previous position as CEO of GEICO CORPORATION (38%-owned, but not controlled, by Berkshire Hathaway), which improved enormously during his stewardship. Fireman's Fund's insurance business is intrinsically more cyclical and less-advantaged than GEICO's core insurance business, which has lower distribution costs from a different, "direct writing" distribution system. Thus Fireman's Fund's business will almost surely be much more difficult to improve permanently than was the case at GEICO. However, Mr. Byrne and other Fireman's Fund executives know all this very well, and, with improvement less spectacular than previous improvement at GEICO, Fireman's Fund and Wes-FIC could both prosper.

Industry-wide conditions, as well as managerial excellence, affect Wes-FIC's prospects under the reinsurance contract with Fireman's Fund. Large premium increases now going into effect throughout the casualty insurance business could provide some welcome tailwind effects instead of the headwind effects of the period just ended, which was one of the worst in history.

We are pleased with our relationship with Fireman's Fund, which has a long and distinguished record, going all the way back to superb performance after the great San Francisco earthquake and fire, and which is affiliated with the even longer established American Express Company, one of the premier corporations in the United States.

However, Wesco's optimism about quality of Fireman's Fund, quality of this reinsurance contract, and possible short-term, industry-wide cyclical improvement, is tempered by a larger and longer view of the reinsurance business. That business has the defect of being too attractive-looking to new entrants for its own good and therefore will always tend to be more or less the opposite of, say, the old business of gathering and rendering dead horses, which tended to contain few and prosperous participants.

Troubles, losses, and insolvencies can come fast as the apparent attractions of the reinsurance business, including its seductive receive-pay-in-advance aspects, lure new entrants and encourage expansions by old occupants. The business was a disaster area in recent years, adversely affected by prices which would have been too low in a stable world, plus inflation, new judicial notions tending to augment insurance coverage beyond limits contemplated when policies were issued, and not-minor degradation of commercial behavior.

No doubt recent commercial behavior degradation, particularly noticeable in the reinsurance business on both sides of the purchase counter, was accelerated by general hardship, demonstrating once again the wisdom of Poor Richard's Almanac: "It is hard for an empty sack to stand upright."

Insurance company subsidiaries of Wesco's parent corporation, Berkshire Hathaway, long active in reinsurance, did continue proper commercial behavior during the recent period of industry-wide problems, but financial results from reinsurance were terrible. Thus Wesco shareholders are being led not only into an extra-hazardous place but also by people who met severe reverses on the last trip.

Is there any reasonable hope for Wesco shareholders that its reinsurance business, whatever its short-term merits, will provide an advantageous long-term journey? Yes, one reason for long-term optimism is present. With recent defaults by reinsurers causing everyone to worry more about quality in promisors, Wes-FIC and Berkshire Hathaway expect that their old-fashioned engineering-type attitudes and financial practices will help create for Wes-FIC an unusual, commercially-useful reputation for issuing trustworthy promises in one or more markets or submarkets wherein most buyers will accept nothing less. Thus, the absence of federal insurance for reinsurance liabilities may create for Wes-FIC a reputation based competitive advantage which is denied to Mutual Savings by FSLIC's support of all Mutual Savings' competitors through insuring their accounts.

All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, decreased to $3,354,000 in 1985 from $4,550,000 in 1984. Sources were (1) rents ($2,219,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant) and (2) interest and dividends from cash equivalents and

marketable securities held by Precision Steel and its subsidiaries and at the parent company level.

Net Gains on Sales of Securities

Wesco's aggregate net gains on sales of securities, combined, after income taxes, increased to $41,523,000 in 1985 from $13,138,000 in 1984.

The 1985 figure includes a big after-tax gain ($34,363,000) from sale of General Foods stock to Philip Morris Company. This gain contained a large amount of windfall profit. When Wesco made its investment in General Foods stock several years ago, because General Foods' executives seemed sensible and the stock was available in the market at a conservative price relative to its value as a share of ownership in a presumably ever-continuing independent entity, it was unprecedented and virtually inconceivable that a corporation the size of General Foods would ever be "bear-hugged" into selling out at an immense premium over the then prevailing market price for its stock. But that is what happened, wholly unpredicted by Wesco, in 1985 as old taboos eroded and the great American takeover game swept into new areas.

Bowery Savings Bank

In 1985 Wesco, in another co-venture with its parent corporation, approved by Wesco's directors in the same manner as the Wes-FIC co-venture, joined a group which invested $100,000,000 cash in a newly organized, New York-chartered savings bank. The new bank then took over the name, assets and liabilities of the insolvent Bowery Savings Bank in the city of New York. The takeover received (1) much needed assistance from FDIC, the federal agency, akin to FSLIC, which insures deposits in banks, and (2) the blessing of New York bank regulators. Wesco invested $9,000,000, other Berkshire Hathaway subsidiaries invested $12,384,000, and other unrelated investors invested the balance of the $100,000,000.

The terms of the FDIC assistance, which include income-assistance payments over many years to the newly organized bank, are extremely complex but can be fairly summarized as far from adequate to assure that the investors will make a profit. This is as it should be when $100 million buys a highly leveraged residual equity position in a $5 billion bank, albeit one with many sick assets.

Any minority position investment with such extreme financial leverage (in effect buying with a 2% down payment), involving a troubled company in a demanding environment, can fairly be called a venture capital type investment for Wesco. In our judgment the prospect for gain justified the risk of loss. The investment involves a small portion (about 5%) of Wesco's consolidated net worth. We consider it financially conservative to risk 3½% of Wesco's net worth (which is roughly the after-tax exposure involved) if we believe a hundred similar bets would, in aggregate, be almost sure to work out successfully.

Consolidated Balance Sheet and Related Discussion

Wesco's consolidated balance sheet (1) retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others and (2) reflects a continuing slow pace of acquisition of additional businesses because few are

found available, despite constant search, at prices deemed rational from the standpoint of Wesco shareholders.

As indicated in Note 3 to the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate cost at December 31, 1985 by about $5 million, down sharply from about $13 million one year earlier.

Wesco's Pasadena real estate, a full block (containing (1) about 125,000 first class net rentable square feet, including Mutual Savings' space, in a modern office building, plus (2) an additional net rentable 34,000 square feet of economically marginal space in old buildings requiring expensive improvement), has a market value substantially in excess of carrying value, demonstrated by (1) mortgage debt ($5,023,000 at 9.25% fixed) against this real estate now exceeding its depreciated carrying value ($3,158,000) in Wesco's balance sheet at December 31, 1985, and (2) substantial current net cash flow (about $1 million per year) to Wesco after debt service on the mortgage. The modern office building is 96% rented, despite a glut of vacant office space in Pasadena. We charge just-below-standard rents and run the building as a sort of first-class club for tenants we admire. With these practices, a prime location and superior parking facilities, we anticipate future increases in cash flow, but at no better rate than the rate of inflation.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity, however, requires some patience, as suitable opportunities are not always present.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and reinsurance subsidiaries and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in very few places. Through this practice of concentration of investments, better understanding is sought with respect to the few decisions made.

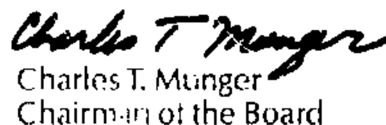
The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 21% in 1983-85, was dependent to a very large extent on securities gains, irregular by nature. The recent ratio is almost certain to decline, quite probably very sharply. Neither possible future acquisitions of other businesses nor possible future securities gains appear likely to cause the recent ratio to continue. The business acquisition game is now crowded with optimistic players who usually force prices for low-leverage acquirers like Wesco to levels where return-on-investment prospects are modest. And, as discussed earlier, the great contribution of 1985 securities gains to Wesco's recent return on shareholders' equity contained a big fluke element. Such fluke gain, rare in any event, tends to come to an investor like Wesco mostly as an unanticipated by-product of an obviously sound investment which does not require any fluke to work out well. Because securities generally traded lower several years ago than they do now, relative to the intrinsic values of the businesses represented by the securities, creating more obviously sound investments then than now, and because

prospects for above-average returns tend to go down as assets managed go up, it is now easy to predict less desirable future results. It is also easy for any sophisticated Wesco shareholder, reviewing Wesco marketable securities disclosed in the 1985 Annual Report, to diagnose (correctly) that the decision-makers are dry of good investment ideas.

Wesco is trying more to profit from always remembering the obvious than from grasping the esoteric (including much modern "strategic planning" and "portfolio theory"). Such an approach, while it has worked fairly well on average in the past and will probably work fairly well over the long-term future, is bound to encounter periods of dullness and disadvantage as it limits action. Moreover, the approach is being applied to no great base position. Wesco is sort of scrambling through the years without owning a single business, even a small one, with enough commercial advantage in place to pretty well assure high future returns on its capital. In contrast, Berkshire Hathaway, Wesco's parent corporation, owns three such high-return businesses.

On January 25, 1986, Wesco increased its regular quarterly dividend from 15½ cents per share to 16½ cents per share, payable March 6, 1986, to shareholders of record as of the close of business on February [illegible] 1986.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.



Charles T. Munger
Chairman of the Board

February 13, 1986

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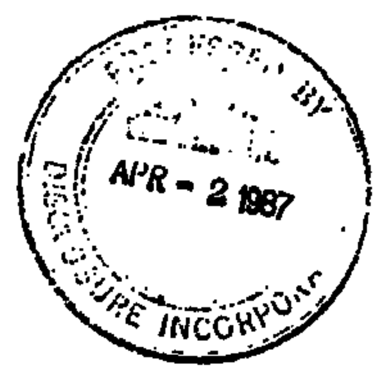


WESCO FINANCIAL CORPORATION

Annual Report 1986

Form 10-K Annual Report 1986

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" operating income (i.e., before all unusual operating income and all net gains from sales of securities) for the calendar year 1986 increased to $11,934,000 ($1.68 per share) from $8,347,000 ($1.17 per share) in the previous year.

Consolidated net income (i.e., after unusual operating income and all net gains from sales of securities) decreased to $16,524,000 ($2.32 per share) from $51,541,000 ($7.24 per share) in the previous year.

A highly unusual capital gain, of a not-likely-to-recur type, from disposition of General Foods stock caused most of the net income in 1985. The table below gives particulars.

Wesco has three major subsidiaries, Mutual Savings, in Pasadena, Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses, and Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged in the reinsurance business. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended December 31, 1986		Year Ended December 31, 1985	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income (loss) of:				
Mutual Savings	$ 2,159	$ .30	$ 3,342	$ .47
Precision Steel businesses	1,701	.24	2,010	.28
Wesco-Financial Insurance business —				
Underwriting	(1,469)	(.21)	(1,584)	(.22)
Investment activity	8,084	1.14	1,225	.17
	6,615	.93	(359)	(.05)
All other "normal" net operating income[2]	1,459	.21	3,354	.47
	11,934	1.68	8,347	1.17
Fluctuation in market value of GNMA futures contract	—	--	1,671	.24
Net gains on sales of securities[3]	4,590	.64	41,523	5.83
Wesco consolidated net income	$16,524	$2.32	$51,541	$7.24

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries.

(3) The 1985 figure includes a $34,463,000 ($4.83 per share) gain realized by Wesco on the sale of its General Foods Corporation common stock to Philip Morris Company in connection with the latter's publicly announced tender offer.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

Mutual Savings

Mutual Savings' "normal" net operating income of $2,159,000 in 1986 represented a decrease of 35% from the $3,342,000 figure the previous year.

Separate balance sheets of Mutual Savings at yearend 1985 and 1986 are set forth at the end of this annual report. They show (1) total savings accounts rising to $282 million from $269 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (probably the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, (4) a loan portfolio (mostly real estate mortgages) of about $79 million at the end of 1986, down 6% from the $83 million at the end of 1985, and (5) favorable effects of securities gains, which caused net worth to decline only $3 million in 1986 despite payment of a dividend of $7.5 million to the parent corporation.

The loan portfolio at the end of 1986, although containing almost no risk of loss from defaults, bore an average interest rate of only 7.48%, probably the lowest for any U.S. savings and loan association and about equal to the average interest rate which now must be paid to hold savings accounts. This, of course, leaves no net interest margin to cover operating costs. However, the unrealized depreciation in the loan portfolio is now more than offset by unrealized appreciation in Mutual Savings' interest-bearing securities and preferred stocks. Such unrealized appreciation at December 31, 1986 was about $17 million.

As pointed out in footnote 14 to the accompanying financial statements, the book value of Wesco's equity in Mutual Savings ($54.8 million at December 31, 1986) overstates the amount realizable, after taxes, from sale or liquidation at book value. If all Mutual Savings' assets, net of liabilities, were to be sold, even pursuant to a plan of complete liquidation, for the $54.8 million in book value reported under applicable accounting convention, the parent corporation would receive much less than $54.8 million after substantial income taxation imposed because about $47 million of what is designated shareholders' equity for accounting purposes is considered bad debt reserves for most tax purposes.

There is, however, in Mutual Savings, not only a buried plus value in unrealized appreciation of securities, but also a buried plus value in real estate. The foreclosed property on hand (mostly 22 largely oceanfront acres in Santa Barbara) has become worth over a long holding period much more than its $1.6 million balance sheet carrying cost. Reasonable, community-sensitive development of this property has been delayed over 11 years in the course of administration of land-use laws. But we are optimistic that delay will end in 1987 and that the Santa Barbara and Montecito communities will be very pleased with development into 32 houses interspersed with large open areas. Mutual Savings plans to make the development first rate in every respect, and unique in the quality of its landscaping.

The buried plus value in real estate is limited by the small number of houses allowed (32) and by the fact that only a minority of such houses (12) will have any significant ocean view. Additional limitation will come from prospective high cost of private streets, sewage and utility improvements and connections, and landscaping. And, most important of all, various charges and burdens imposed by governmental bodies will drastically reduce our potential recovery from what it would have been had the zoning and development climate of the early 1970s continued into 1987.

Balancing all merits and demerits, Mutual Savings, as it has been managed under present conditions by the writer and others, continues to be a mediocre business from the shareholders' point of view. Mutual Savings' good points are: (1) high asset quality and sound balance sheet; (2) a maturity match of interest-bearing assets and liabilities which makes risk of insolvency near zero, whatever happens to interest rates; and (3) a deserved reputation for high quality service to account holders, achieved at below-average cost to the institution in an efficient one-large-office operation, as distinguished from a many-small-branch-offices operation. Mutual Savings' bad points are: (1) all recent growth in savings accounts, considered on an incremental-effects basis, has been loss business because interest and other costs incurred exceed income obtained by employing proceeds in short-term interest-bearing assets; (2) a burdensome position under the FSLIC account-insurance system causes payments of ever-higher amounts into the system to help bail out more venturesome savings and loan associations which become insolvent, with the payments being required despite the fact that Mutual Savings imposes almost no risk on FSLIC; (3) "normal" net operating income is below an acceptable rate of return on present book value of shareholders' equity, with such return reaching an acceptable level over recent years only with help from securities gains and other unusual items; (4) it would not be easy to leave the savings and loan business, should this course of action ever be desired, without a large income tax burden of a type not applied to corporations other than savings and loan associations; (5) as explained in last year's annual report, the regulatory structure of the savings and loan business creates a competitive situation in which it is hard to make respectable profits through careful operations; and (6) management has not yet found an acceptable remedy for any of the previously listed bad points, despite years of trying.

Moreover, comparisons of post-1984 financial results for Mutual Savings with results for many other and more typical savings and loan associations in California continue to leave Mutual Savings looking inferior, to put it mildly. As interest rates went down these other associations, which have greater financial leverage and operated less fearfully than Mutual Savings during former high-interest periods, came to have loan and investment portfolios which (1) now are worth more on average than book value and (2) now produce a high return on book value of shareholders' equity, after deduction of operating expenses and interest to account holders at present rates. Any Wesco shareholder who thinks Mutual Savings has any expertise in predicting and profiting from interest rate changes can look at the 1985-1986 record and despair.

Despite the fact that some other savings and loan associations did much better after 1984 than Mutual Savings, and are now much better poised to report good figures for 1987, we plan to continue operating only in ways acceptable in our own judgment, anticipating as a consequence widely fluctuating and sometimes inadequate returns. In the future, however, Mutual Savings will make and purchase more loans. Now that Mutual Savings' old mortgage loans have declined in amount and increased in market value (the market value increase being caused both by a decline in generally prevailing interest rates and by a shortening of remaining loan life), new loans will be added as seems wise, with a target that at least 60% of assets be in housing-related loans. New direct loans aggregating $9 million were made in 1986, all adjustable rate mortgages with no cap on future interest rate changes but with an extremely low "spread" for the lender. In recent months the total of all loans on hand has risen as new loans made exceeded principal payoffs on old loans.

With assets not employed in direct real-estate lending, Mutual Savings continues not only to make payments to FSLIC far in excess of fair charges for risks imposed on FSLIC but also to employ a large part of total assets in short-term loans to the Federal Home Loan Bank. These practices are pro-social but will continue to reduce profits.

Mutual Savings also continues to support the Federal Home Loan Bank Board in its efforts to change the present rules of the savings and loan business to augment average soundness of FSLIC-insured associations and prevent recurrence of widespread insolvencies like those now bedevilling the industry.

Precision Steel

Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, was acquired for approximately $15 million on February 28, 1979. The price was roughly book value for a company which carried its inventories on a conservative LIFO accounting basis and which contained significant cash balances. More important, the company had reached its position from a modest beginning through maintenance of sound, customer-oriented business values inculcated over a long time by a gifted founder and his successors. Precision Steel owns a well-established steel service center business and a subsidiary engaged in the manufacture and distribution of tool room supplies and other specialty metal products.

Precision Steel's businesses contributed $1,701,000 to "normal" net operating income in 1986, down 15% compared with $2,010,000 in 1985. The decrease in 1986 profit occurred in spite of increased revenues (up 2% to $52,304,000).

Under the skilled leadership of David Hillstrom, Precision Steel's businesses are now quite satisfactory, taking into account the financial leverage put into Wesco's consolidated picture incident to their acquisition.

Shortly after Wesco's purchase of Precision Steel, a substantial physical expansion of steel warehousing facilities was authorized, involving a new building in Charlotte, North Carolina. The new building and the whole North Carolina operation are now very successful, contributing $10,172,000 to 1986 sales at a profit margin higher than has prevailed in the long-established Chicago headquarters' facility.

Precision Steel's businesses, despite their mundane nomenclature, are steps advanced on the quality scale from mere commodity-type businesses. Many customers of Precision Steel, needing dependable supply on short notice of specialized grades of high-quality, cold-rolled strip steel, reasonable prices, technical excellence in cutting to order, and remembrance when supplies are short, rightly believe that they have no fully comparable alternative in Precision Steel's market area. Indeed, many customers at locations remote from Chicago and Charlotte (for instance, Los Angeles) seek out Precision Steel's service.

Wesco remains interested in logical expansion of Precision Steel's businesses, using available liquid assets.

Wesco-Financial Insurance Company

A new business was added to the Wesco group in 1985, in co-venture with Wesco's 80% owner and ultimate parent corporation, Berkshire Hathaway Inc.

With the enthusiastic approval of all Wesco's directors, including substantial Wesco shareholders in the Peters and Caspers families, without whose approval such action would not have been taken, Wesco in 1985 invested $45 million in cash equivalents in a newly organized, wholly owned, Nebraska-chartered insurance company, Wesco-Financial Insurance Company ("Wes-FIC"). Another $36.2 million was invested in January 1986.

The new subsidiary, Wes-FIC, has reinsured, through another Berkshire Hathaway insurance company subsidiary as intermediary-without-profit, 2% of the entire book of insurance business of the long-established Fireman's Fund Corp. (listed on the NYSE). Wes-FIC thereby assumed the benefits and burdens of Fireman's Fund's prices, costs and losses under a contract covering all insurance premiums earned by Fireman's Fund during a four-year period commencing September 1, 1985. The arrangement puts Wes-FIC in almost exactly the position it would have been in if it, instead of Fireman's Fund, had directly written 2% of the business. Differences in results should occur only from the investment side of insurance, as Wes-FIC, instead of Fireman's Fund, invests funds from "float" generated. Wes-FIC's share of premiums earned in 1986 exceeded $67 million.

Wes-FIC's separate financial statements, covering the brief period of its existence, September 1, 1985, to December 31, 1986, are included on page 30 of this Annual Report, and show that Wes-FIC's net income for 1986 was $6,967,000 versus a small deficit ($359,000) for its first 4 months of operation in 1985. The 1986 net income figure included securities gains, net of income taxes, of $352,000.

It is in the nature of even the finest casualty insurance businesses that in keeping their accounts they must estimate and deduct all future costs and losses from premiums already earned. Uncertainties inherent in this undertaking make financial statements more mere "best honest guesses" than is typically the case with accounts of non-insurance-writing corporations. And the reinsurance portion of the casualty insurance business, because it contains one or more extra links in the loss-reporting chain, usually creates more accounting uncertainty than the non-reinsurance portion. Wesco shareholders should remain aware, not only of the inherent imperfections of Wes-FIC's accounting, but also of the inherent cyclicality of its business.

However, Wesco hopes for: (1) a reasonable return on its investment over the four years of the Fireman's Fund reinsurance contract, and (2) possible future reinsurance contracts with other insurers.

We very much like our association with Fireman's Fund, a real class operation, and with Jack Byrne, its CEO, who displayed great integrity, intelligence and vigor in returning GEICO Corporation to glory before he took his present position.

All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, decreased to $1,459,000 in 1986 from $3,354,000 in 1985. Sources were (1) rents ($2,229,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant) and (2) interest and dividends from cash equivalents and marketable securities held by Precision Steel and its subsidiaries and at the parent company level. The great decrease in interest and dividends received in this "other income" category was caused by the transfer of assets to Wes-FIC, where income is now classified as insurance income.

Net Gains on Sales of Securities

Wesco's aggregate net gains on sales of securities, combined, after income taxes, decreased to $4,590,000 in 1986 from $41,523,000 in 1985.

Bowery Savings Bank

In 1985 Wesco, in another co-venture with its parent corporation, approved by Wesco's directors in the same manner as the Wes-FIC co-venture, joined a group which invested $100,000,000 cash in a newly organized, New York-chartered savings bank. The new bank then took over the name, assets and liabilities of the insolvent Bowery Savings Bank in the city of New York. The takeover received (1) much needed assistance from FDIC, the federal agency, akin to FSLIC, which insures deposits in banks, and (2) the blessing of New York bank regulators. Wesco invested $9,000,000, other Berkshire Hathaway subsidiaries invested $12,384,000, and other unrelated investors invested the balance of the $100,000,000.

The terms of the FDIC assistance, which include income-assistance payments over many years to the newly organized bank, are extremely complex but can be fairly summarized as far from adequate to assure that the investors will make a profit. This is as it should be when $100 million buys a highly-leveraged residual equity position in a $5 billion bank, albeit one with many sick assets.

Any minority-position investment with such extreme financial leverage (in effect buying with a 2% down payment), involving a troubled company in a demanding environment, can fairly be called a venture-capital type investment for Wesco. In our judgment, the prospect for gain justified the risk of loss.

This investment continues to be carried at cost in Wesco's accompanying financial statements, and we continue in guarded optimism regarding our position.

Consolidated Balance Sheet and Related Discussion

Wesco's consolidated balance sheet (1) retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others and (2) reflects a continuing slow pace of acquisition of additional businesses because few are found available, despite constant search, at prices deemed rational from the standpoint of Wesco shareholders.

As indicated in Note 3 to the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate carrying value at December 31, 1986 by about $13 million, up modestly from about $5 million one year earlier. The consolidated aggregate market value of all marketable securities, including bonds and other fixed-income securities, exceeded aggregate carrying value by about $23 million. As earlier noted, about $17 million of this unrealized appreciation lies within the savings and loan subsidiary.

Wesco's Pasadena real estate, a full block (containing (1) about 125,000 first class net rentable square feet, including Mutual Savings' space, in a modern office building, plus (2) an additional net rentable 34,000 square feet of economically marginal space in old buildings requiring expensive improvement), has a market value substantially in excess of carrying value, demonstrated by (1) mortgage debt ($4,940,000 at 9.25% fixed) against this real estate now exceeding its depreciated carrying value ($3,091,000) in Wesco's balance sheet at December 31, 1986, and (2) substantial current net cash flow (about $1 million per year) to Wesco after debt service on the mortgage. The modern office building is 96% rented, despite a glut of vacant office space in Pasadena. We charge just-below-standard rents and run the building as a sort of first-class club for tenants we admire. With these practices, a prime location and superior parking facilities, we anticipate future increases in cash flow, but at no better rate than the rate of inflation.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity, however, requires patience, as suitable opportunities are not always present.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and reinsurance subsidiaries and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in very few places. Through this practice of concentration of investments, better understanding is sought with respect to the few decisions made.

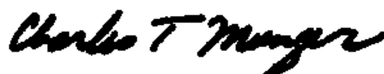
The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 19% in 1984-86, was dependent to a very large extent on securities gains, irregular by nature. This recent ratio is almost certain to continue to decline, probably sharply, as it did in 1986. Neither possible future acquisitions of other businesses nor possible future securities gains appear likely to help much in the short term. The business acquisition game continues to be crowded with optimistic players who usually force prices for low-leverage acquirers like Wesco to levels where return-on-investment prospects are modest. And future securities gains are likely to prove harder to come by for very simple reasons. Because securities generally traded lower several years ago than they do now, relative to the intrinsic values of the businesses represented by the securities, creating more obviously sound investments then than now, and because prospects for above-average returns tend to go down as assets managed go up, it is now, early in 1987, even easier than it was early in 1986, to predict less desirable future results. It is also easy for any sophisticated Wesco shareholder, reviewing either (i) this virtual reprint of last year's letter or (ii) Wesco's marketable securities disclosed herein, to diagnose (correctly) that the decision-makers are now even more dry of good ideas than they were a year earlier.

The considerable, and higher than normal, liquidity of Wesco's consolidated financial position as this is written does not result from our forecast that business conditions are about to worsen, or that interest rates are about to rise, or that common stock prices are about to fall. Wesco's condition results, instead, from our simply not finding opportunities for more aggressive use of capital with which we are comfortable.

Wesco continues to try more to profit from always remembering the obvious than from grasping the esoteric (including much modern "strategic planning" and "portfolio theory"). Such an approach, while it has worked fairly well on average in the past and will probably work fairly well over the long-term future, is bound to encounter periods of dullness and disadvantage as it limits action. Moreover, the approach is being applied to no great base position. Wesco is sort of scrambling through the years without owning a single business, even a small one, with enough commercial advantage in place to pretty well assure high future returns on its capital. In contrast, Berkshire Hathaway, Wesco's parent corporation, owns a fair number of such high-return businesses.

On January 22, 1987, Wesco increased its regular quarterly dividend from 16½ cents per share to 17½ cents per share, payable March 12, 1987, to shareholders of record as of the close of business on February 20, 1987.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.



Charles T. Munger
Chairman of the Board

February 13, 1987

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WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" operating income (i.e., before all unusual operating income and all net gains from sales of securities) for the calendar year 1987 increased to $16,612,000 ($2.33 per share) from $11,934,000 ($1.68 per share) in the previous year.

Consolidated net income (i.e., after unusual operating losses and all net gains from sales of securities) decreased to $15,213,000 ($2.14 per share) from $16,524,000 ($2.32 per share) in the previous year.

Wesco has three major subsidiaries, Mutual Savings, in Pasadena, Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses, and Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged in the reinsurance business. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended			
	December 31, 1987		December 31, 1986	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income (loss) of:				
Mutual Savings	$ 2,895	$ .41	$ 2,159	$ .30
Precision Steel's businesses	2,450	.34	1,701	.24
Wesco-Financial insurance business —				
Underwriting	(1,394)	(.19)	(1,469)	(.21)
Investment activity	10,853	1.52	8,084	1.14
	9,459	1.33	6,615	.93
All other "normal" net operating income[2]	1,808	.25	1,459	.21
	16,612	2.33	11,934	1.68
Writeoff by Mutual Savings of prepaid FSLIC insurance premiums[3]	(1,935)	(.27)	—	—
Flood loss at Precision Steel	(672)	(.09)	—	—
Net gains on sales of securities	1,208	.17	4,590	.64
Wesco consolidated net income	$15,213	$2.14	$16,524	$2.32

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries.

(3) Necessitated by the Federal Home Loan Bank's elimination of the savings and loan industry's nearly $1-billion secondary insurance reserve, consisting of deposit insurance premiums prepaid to FSLIC, the U.S agency which insures accounts in savings and loan associations.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

Mutual Savings

Mutual Savings' "normal" net operating income of $2,895,000 in 1987 represented an increase of 34% from the $2,159,000 figure the previous year.

However, this "normal" figure of $2,895,000 for Mutual Savings' 1987 earnings is created by ignoring as abnormal an after-tax charge of $1,935,000 from writeoff of prepayments of deposit-insurance premiums. The premiums had been prepaid in previous years to FSLIC, the U.S. agency which insures accounts in savings and loan associations. Since FSLIC has been grievously impaired by widespread failure of insured associations and continues to be insolvent, and since its long-term source of support is collection of premiums which the savings and loan industry is *compelled* to pay, it may well be questioned whether FSLIC-related charges far in excess of past experience should on that account now be excluded from the "normal" as we do in this explanatory letter. Mutual Savings' position, relative to FSLIC, is like that of the owner of a concrete pier, mostly underwater, compelled to buy fire insurance on a pooled-rate basis with a group of oily-rag collectors, many of whom have already had but not reported their fires, with the result that no provision for such fires has yet been made in pooled-basis premium rates. Such an owner probably has not yet had his last unpleasant surprise from his insurance costs. Even so, we chose "unusual" classification for the FSLIC special charge in 1987, because it is not certain to be repeated.

Separate balance sheets of Mutual Savings at yearend 1986 and 1987 are set forth at the end of this annual report. They show (1) total savings accounts rising to $287 million from $282 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (probably the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, and (4) a loan portfolio (mostly real estate mortgages) of about $139 million at the end of 1987, up 76% from the $79 million at the end of 1986.

The loan portfolio at the end of 1987, although containing almost no risk of loss from defaults, bore an average interest rate of only 8.38%, probably near the lowest among U.S. savings and loan associations, but up sharply from 7.48% at the end of 1986. There is now no significant unrealized depreciation in the loan portfolio, while unrealized appreciation in Mutual Savings' interest-bearing securities and preferred stocks at December 31, 1987 was about $9 million.

As pointed out in Note 10 to the accompanying financial statements, the book value of Wesco's equity in Mutual Savings ($56.6 million at December 31, 1987) overstates the amount realizable, after taxes, from sale or liquidation at book value. If all Mutual Savings' assets, net of liabilities, were to be sold, for the $56.6 million reported as book value, the parent corporation would receive much less than $56.6 million after substantial income taxation imposed because about $47 million of what is designated shareholders' equity for accounting purposes is considered bad debt reserves for most tax purposes.

Mutual Savings has not only a buried plus value in unrealized appreciation of securities, but also a buried plus value in real estate. The foreclosed property on hand (mostly 22 largely oceanfront acres in Santa Barbara) has become worth over a long holding period much more than its $2.0 million balance sheet carrying cost. Reasonable, community-sensitive development of this property has been delayed over 12 years in the course of administration of land-use laws. But, miraculous to report, grading is now actually under way on the property for an authorized development into 31 houses interspersed with large open areas. Mutual Savings plans to make the development first rate in every respect, and unique in the quality of its landscaping.

The buried plus value in real estate is limited by the small number of houses allowed (31) and by the fact that only a minority of such houses (11) will have any significant ocean view. Additional limitation will come from prospective high cost of private streets, sewage and utility improvements and connections, and landscaping. And, most important of all, various charges and burdens, including heavy archaeological obligations imposed by governmental bodies, will drastically reduce our potential recovery from what it would have been had the zoning and development climate of the early 1970s continued into 1988.

Mutual Savings is now a "qualified thrift lender" under the Federal regulatory definition requiring 60% of assets in various housing-related categories. Substantially all loans receivable have either short expected lives or bear interest rates which fluctuate with the market to 25% per annum or more.

While the "spread" between Mutual Savings' average interest rates paid on savings and received on loans remains too low to provide respectable profits, such spread is improving. Moreover, the disadvantage from inadequate spread continues to be offset to a considerable degree by the effect of various forms of tax-advantaged investment, primarily preferred stock. The negative side of this tax-advantaged antidote to inadequate interest rate margin on loans is the risk that preferred stock, with its fixed dividend and long life, will decline in value and not provide enough income to cover Mutual Savings' interest costs, if the general level of interest rates should sharply rise. In view of this risk, Mutual Savings' total commitment to preferred stock is kept conservative, relative to the amount of its net worth.

All in all, Mutual Savings continues to be a mediocre business, albeit one which is both (1) improving slightly and (2) expected to produce an average return of at least 10% per annum on the after-tax proceeds which could be realized from its liquidation. And, of course, we are making needed loans in our community while we try to behave as if there were no federal deposit-insurance system. Such an institution may find a bigger role as the years go by.

Precision Steel

The businesses of Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, contributed $2,450,000 to "normal" net operating income in 1987, up 44% compared with $1,701,000 in 1986. The increase in 1987

profit occurred in spite of only a modest increase in revenues (up 5% to $54,843,000).

The "normal" net operating income figure does not include the adverse effect of an after-tax charge of $672,000 from a flood loss following a severe rainstorm in August, during which nine inches of rain fell in a twenty-four hour period. We consider such a flood a once-in-a-hundred-years type of occurrence, and have no hesitation as we exclude the item from "usual" results in our explanatory letter.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1987 provided an extraordinary return even without taking into account the financial leverage put into Wesco's consolidated picture incident to their acquisition.

The good financial results have an underlying reason. Precision Steel's businesses, despite their mundane nomenclature, are steps advanced on the quality scale from mere commodity-type businesses. Many customers of Precision Steel, needing dependable supply on short notice of specialized grades of high-quality, cold-rolled strip steel, reasonable prices, technical excellence in cutting to order, and remembrance when supplies are short, rightly believe that they have no fully comparable alternative in Precision Steel's market area. Indeed, many customers at locations remote from Chicago and Charlotte (for instance, Los Angeles) seek out Precision Steel's service.

Wesco-Financial Insurance Company

A new business was added to the Wesco group in 1985, in co-venture with Wesco's 80% owner and ultimate parent corporation, Berkshire Hathaway Inc.

With the enthusiastic approval of all Wesco's directors, including substantial Wesco shareholders in the Peters and Caspers families, without whose approval such action would not have been taken, Wesco in 1985 invested $45 million in cash equivalents in a newly organized, wholly owned insurance company, Wesco-Financial Insurance Company ("Wes-FIC"). Another $45 million was invested in 1986 and 1987.

The new subsidiary, Wes-FIC, has reinsured, through another Berkshire Hathaway insurance company subsidiary as intermediary-without-profit, 2% of the entire book of insurance business of the long-established Fireman's Fund Corp. (listed on the NYSE). Wes-FIC thereby assumed the benefits and burdens of Fireman's Fund's prices, costs and losses under a contract covering all insurance premiums earned by Fireman's Fund during a four-year period commencing September 1, 1985. The arrangement puts Wes-FIC in almost exactly the position it would have been in if it, instead of Fireman's Fund, had directly written 2% of the business. Differences in results should occur only from the investment side of insurance, as Wes-FIC, instead of Fireman's Fund, invests funds from "float" generated. Wes-FIC's share of premiums earned in 1987 exceeded $73 million.

Wes-FIC's net income for 1987 was $9,468,000, versus $6,967,000 for 1986. The net income figures included securities gains, net of income taxes, of $9,000 in 1987 and $352,000 in 1986. Wes-FIC's 1987 net income benefitted by about

$1 million because of an unusual adjustment to its income tax provision caused by the Tax Reform Act of 1986.

It is in the nature of even the finest casualty insurance businesses that in keeping their accounts they must estimate and deduct all future costs and losses from premiums already earned. Uncertainties inherent in this undertaking make financial statements more mere "best honest guesses" than is typically the case with accounts of non-insurance-writing corporations. And the reinsurance portion of the casualty insurance business, because it contains one or more extra links in the loss-reporting chain, usually creates more accounting uncertainty than the non-reinsurance portion. Wesco shareholders should remain aware, not only of the inherent imperfections of Wes-FIC's accounting, but also of the inherent cyclicality of its business.

However, Wesco hopes for: (1) a reasonable return on its investment over the four years of the Fireman's Fund reinsurance contract, and (2) possible future reinsurance contracts with other insurers.

All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, increased to $1,808,000 in 1987 from $1,459,000 in 1986. Sources were (1) rents ($2,272,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant) and (2) interest and dividends from cash equivalents and marketable securities held by Precision Steel and its subsidiaries and at the parent company level.

Net Gains On Sales Of Securities

Wesco's aggregate net gains on sales of securities, combined, after income taxes, decreased to $1,208,000 in 1987 from $4,590,000 in 1986.

Bowery Savings Bank

In 1985 Wesco, in another co-venture with its parent corporation, approved by Wesco's directors in the same manner as the Wes-FIC co-venture, joined a group which invested $100,000,000 cash in a newly organized, New York-chartered savings bank. The new bank then took over the name, assets and liabilities of the insolvent Bowery Savings Bank in the city of New York. The takeover received (1) much needed assistance from FDIC, the federal agency, akin to FSLIC, which insures deposits in banks, and (2) the blessing of New York bank regulators. Wesco invested $9,000,000, other Berkshire Hathaway subsidiaries invested $12,384,000, and other unrelated investors invested the balance of the $100,000,000.

The terms of the FDIC assistance were extremely complex but can be fairly summarized as far from adequate to assure that the investors would make a profit. This is as it should be when $100 million buys a highly-leveraged residual equity position in a $5 billion bank, albeit one with many problems.

The investment continued to be carried at cost in Wesco's accompanying year-end financial statements, but it was sold, as part of a friendly acquisition of Bowery

by a large and reputable company, on January 31, 1988, at an after-tax profit for Wesco of about $5 million.

Richard Ravitch was the organizing leader in the group which revitalized Bowery Savings Bank, acted as its CEO and negotiated its sale. We take this opportunity to doff our hat to him for a job well done. We have similar admiration for our other co-investors, particularly the Tisch family and Richard Rosenthal. Mr. Rosenthal was a former Salomon partner (see below) who died in a tragic air crash in the midcourse of our venture.

Salomon Inc

On October 1, 1987 Wesco and certain of its wholly owned subsidiaries purchased 100,000 newly issued shares of Series A Cumulative Convertible Preferred Stock, without par value, of Salomon Inc ("Salomon"), at a cost of $100 million. Salomon's primary business is transacted by its subsidiary, Salomon Brothers, a leading securities firm. Our investment was part of a $700 million transaction in which other subsidiaries of Berkshire Hathaway Inc., Wesco's parent, invested $600 million. Principal terms of the transaction include the following: (1) the new preferred stock will pay dividends at the annual rate of 9%; (2) each preferred share, purchased at a cost of $1,000, will be convertible into 26.31579 shares of Salomon common stock on or after October 31, 1990, or earlier if certain extraordinary events occur; and (3) the preferred stock is subject to mandatory redemption provisions requiring the retirement, at $1,000 per share plus accrued dividends, of 20% of the issue on each October 31, beginning in 1995, so long as any shares of preferred stock remain outstanding.

At the stated conversion price of the preferred stock, a profit (subject to certain procedural requirements) will be realizable whenever, after October 31, 1990, the common stock of Salomon (listed NYSE) trades at over $38 per share. At the time of our commitment to buy the new preferred, the common stock of Salomon was selling in the low 30s. However, shortly after the ink dried on Wesco's new stock certificates, the October 19, 1987 "Black Monday" stock market crash occurred, which caused temporary but substantial operating losses plus a lowered credit rating at Salomon. Although Salomon, among securities firms, suffered only its rough share of the general debacle, its common stock at one time after the crash traded as low as 16⅛.

Fortunately, as the conversion privilege we had bargained for declined in value along with the price of Salomon common stock, interest rates also declined, which made our fixed 9% annual preferred stock dividend more valuable. We believe that, all factors considered, at December 31, 1987 our $100 million investment in preferred stock of Salomon was still worth about $98 million.

We much admire the way Salomon and its leader, John Gutfreund, are adjusting operations to cope with new and adverse conditions. They seem ahead of the game to us, compared with competitors, and they work from the sound base of an honored name, affixed to an organization deep in talent and known for hard work.

Berkshire Hathaway's Chairman, Warren Buffett, and the undersigned joined the board of Salomon on October 28, 1987, and are very pleased with the new association.

Consolidated Balance Sheet and Related Discussion

Wesco's consolidated balance sheet (1) retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others and (2) reflects a continuing slow pace of acquisition of additional businesses because few are found available, despite constant search, at prices deemed rational from the standpoint of Wesco shareholders.

As indicated on the accompanying consolidated balance sheet, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate carrying value at December 31, 1987 by about $6 million, down significantly from about $13 million one year earlier. The consolidated aggregate market value of all marketable securities, including bonds and other fixed-income securities, exceeded aggregate carrying value by about $12 million. As earlier noted, about $9 million of this unrealized appreciation lies within the savings and loan subsidiary.

Wesco's Pasadena real estate, a full block (containing (1) about 125,000 first-class net rentable square feet, including Mutual Savings' space, in a modern office building, plus (2) an additional net rentable 34,000 square feet of economically marginal space in old buildings requiring expensive improvement), has a market value substantially in excess of carrying value, demonstrated by (1) mortgage debt ($4,850,000 at 9.25% fixed) against this real estate now exceeding its depreciated carrying value ($3,164,000) in Wesco's balance sheet at December 31, 1987, and (2) substantial current net cash flow (about $1 million per year) to Wesco after debt service on the mortgage. The modern office building is 99% rented, despite a glut of vacant office space in Pasadena. We charge just-below-standard rents and run the building as a sort of first-class club for tenants we admire. With these practices, a prime location and superior parking facilities, we anticipate future increases in cash flow, but at no better rate than the rate of inflation.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity, however, requires patience, as suitable opportunities are not always present.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and reinsurance subsidiaries and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in very few places. Through this practice of concentration of investments, better understanding is sought with respect to the few decisions made.

The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 15% in 1985-87, was dependent to a very large extent on securities gains, irregular by nature. This recent ratio is almost certain to continue to decline, probably sharply, as it did in 1987. Neither possible future acquisitions of other businesses nor possible future securities gains appear likely to help much in the short term. The business acquisition game continues to be crowded with optimistic players who usually force prices for low-leverage acquirers like Wesco to levels where return-on-investment prospects are modest. And future securities gains are likely to prove harder to come by for very simple reasons. Because securities generally traded lower several years ago than they do now, relative to the intrinsic values of the businesses represented by the securities, creating more obviously sound investments then than now, and because prospects for above-average returns tend to go down as assets managed go up, it is now, early in 1988, even easier than it was early in 1986, to predict less desirable future results. It is also easy for any sophisticated Wesco shareholder, reviewing either (1) this virtual reprint of last year's letter or (2) Wesco's marketable securities disclosed herein, to diagnose (correctly) that the decision-makers are now even more dry of good ideas than they were two years earlier.

The considerable, and higher than desired, liquidity of Wesco's consolidated financial position as this is written does not result from our forecast that business conditions are about to worsen, or that interest rates are about to rise, or that common stock prices are about to fall. Wesco's condition results, instead, from our simply not finding opportunities for more aggressive use of capital with which we are comfortable.

Wesco continues to try more to profit from always remembering the obvious than from grasping the esoteric (including much modern "strategic planning" and "portfolio theory"). Such an approach, while it has worked fairly well on average in the past and will probably work fairly well over the long-term future, is bound to encounter periods of dullness and disadvantage as it limits action.

Moreover, our approach is being applied to no great base position. Wesco has only a tiny fraction of its total intrinsic value in businesses with enough commercial advantage in place to assure permanent high future returns on capital employed. In contrast, Berkshire Hathaway, Wesco's parent corporation, has a larger proportion of its intrinsic value in durable high-return businesses.

Some historical explanation for the current situation becomes appropriate here. When Wesco's parent corporation acquired control, Wesco's activities were almost entirely limited to holding (1) some surplus cash, plus (2) a multi-branch savings and loan association which had many very long-term, fixed-rate mortgages, offset by interest-bearing demand deposits. The acquisition of this intrinsically disadvantageous position was unwisely made, alternative opportunities considered, because the acquirer was overly influenced by a price considered to be moderately below liquidating value. Under such circumstances, acquisitions have a way of producing, on average, for acquirers who are not quick-turn operators, low to moderate long-term results. This happens because any advantage from a starting "bargain" gets

swamped by effects from change-resistant mediocrity in the purchased business. Such normal effects have not been completely avoided at Wesco, despite some successful activities, including recent investment in General Foods.

Over the long term, a corporation like Wesco, with no significant proportion of intrinsic value in great businesses, is like a tortoise in a race of hares. And, as noted above, this particular tortoise faces the race with an unoriginal and conservative approach.

However, there are respectable precedents for our approach. The novelist Hardy, who believed that the natural outcome of ambition was getting clobbered, advocated the logical preventative of aiming low. And people known for outcomes far too good to have been expected by Hardy have mined a branch of the same vein. Consider this statement from Newton: "If I have seen further than other men, it is by standing on the shoulders of giants". And this from Mozart (as approvingly quoted by the distinguished advertising creator, David Ogilvy): "I never tried to compose anything original in my life".

It is occasionally possible for a tortoise, content to assimilate proven insights of his best predecessors, to outrun hares which seek originality or don't wish to be left out of some crowd folly which ignores the best work of the past. This happens as the tortoise stumbles on some particularly effective way to apply the best previous work, or simply avoids standard calamities. Anyway, we hope so. And so should recent purchasers of Wesco stock who have not only bet on a tortoise but also, by paying prices in the mid forties, given odds.

On January 28, 1988, Wesco increased its regular quarterly dividend from 17½ cents per share to 18½ cents per share, payable March 15, 1988, to shareholders of record as of the close of business on February 26, 1988.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Charles T. Munger
Chairman of the Board

February 26, 1988

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WESCO FINANCIAL CORPORATION

Annual Report 1988

Form 10-K Annual Report 1988

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" operating income (i.e., before all unusual operating income and all net gains from sales of securities) for the calendar year 1988 increased to $23,564,000 ($3.31 per share) from $16,612,000 ($2.33 per share) in the previous year.

Consolidated net income (i.e., after unusual operating losses and all net gains from sales of securities) increased to $30,089,000 ($4.22 per share) from $15,213,000 ($2.14 per share) in the previous year.

Wesco has three major subsidiaries, Mutual Savings, in Pasadena, Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses, and Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged principally in the reinsurance business. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended			
	December 31, 1988		December 31, 1987	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income (loss) of:				
Mutual Savings	$ 4,694	$ .66	$ 2,895	$ .41
Wesco-Financial Insurance business	12,094	1.70	9,459	1.33
Precision Steel's businesses	3,167	.44	2,450	.34
All other "normal" net operating income[2]	3,609	.51	1,808	.25
	23,564	3.31	16,612	2.33
Gain on sale of interest in Bowery Savings Bank	4,836	.68	—	—
Net gains on sales of marketable securities	1,689	.23	1,208	.17
Writeoff by Mutual Savings of prepaid FSLIC insurance premiums[3]	—	—	(1,935)	(.27)
Flood loss at Precision Steel	—	—	(672)	(.09)
Wesco consolidated net income	$30,089	$4.22	$15,213	$2.14

(1) All figures are net of income taxes.
(2) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries.
(3) Necessitated by the Federal Home Loan Bank's elimination of the savings and loan industry's nearly $1-billion secondary insurance reserve, consisting of deposit insurance premiums prepaid to FSLIC, the U.S. agency which insures accounts in savings and loan associations.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

Mutual Savings

Mutual Savings' "normal" net operating income of $4,694,000 in 1988 represented an increase of 62% from the $2,895,000 figure the previous year.

The high percentage increase in 1988 was partly fluke. The interest rate curve happened to be precisely adapted to Mutual Savings' needs during most of the year, and already, in 1989, net interest margins are impaired as short-term rates and intermediate-term rates have become more or less identical.

Moreover, these "normal-income" figures come from a decidedly abnormal savings and loan association.

Separate balance sheets of Mutual Savings at yearend 1987 and 1988 are set forth at the end of this annual report. They show (1) total savings accounts rising to $289 million from $287 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (near the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, and (4) a loan portfolio (mostly real estate mortgages) of about $137 million at the end of 1988, down slightly from $139 million at the end of 1987.

The loan portfolio at the end of 1988, although containing almost no risk of loss from defaults, bore an average interest rate of only 8.70%, probably near the lowest among U.S. savings and loan associations, but up moderately from 8.38% at the end of 1987. Because the loan portfolio is almost entirely made up of instruments of short maturity or bearing interest rates that adjust automatically with the market, there is now less unrealized depreciation in the loan portfolio than the net unrealized appreciation in Mutual Savings' interest-bearing securities and public utility preferred stocks. That appreciation at December 31, 1988 was about $7.5 million.

While the "spread" between Mutual Savings' average interest rates paid on savings and received on loans remains too low to provide respectable profits, this "spread" improved last year. Moreover, the disadvantage from inadequate "spread" has been reduced in each recent year by the effect of various forms of tax-advantaged investment, primarily preferred stock and municipal bonds. The negative side of this tax-advantaged antidote to inadequate interest rate margin on loans is the risk that preferred stock and municipal bonds, with their fixed yield and long life, will decline in value and not provide enough income to cover Mutual Savings' interest costs, if the general level of interest rates should sharply rise. In view of this risk, Mutual Savings' total commitment is kept conservative, relative to the amount of its net worth.

Mutual Savings remains a "qualified thrift lender" under the federal regulatory definition requiring 60% of assets in various housing-related categories. It plans to continue keeping substantially all loans receivable either with short expected lives or with interest rates that fluctuate with the market. All new variable-rate loans are "capped" at the 25% per annum level, which is over ten percentage points higher than the normal 2½-points-over-market "cap" offered by competing associations. Naturally, to gain this extra protection from interest rate increase, Mutual Savings

"pays" by (1) getting lower "spreads" over an interest rate index, and (2) not being able to make loans in amounts desired.

As pointed out in Note 10 to the accompanying financial statements, the book value of Wesco's equity in Mutual Savings ($49.7 million at December 31, 1988) overstates the amount realizable, after taxes, from sale or liquidation at book value. If all Mutual Savings' assets, net of liabilities, were to be sold for the $49.7 million reported as book value, the parent corporation would receive much less than $49.7 million after substantial income taxation imposed because about $47 million of what is designated shareholders' equity for accounting purposes is considered bad debt reserves for most tax purposes.

Mutual Savings has not only a buried value in unrealized appreciation of securities but also a buried value in real estate. The foreclosed property on hand (mostly 22 acres at or near the oceanfront in Santa Barbara) has become worth over a long holding period considerably more than its $5.4 million balance sheet carrying cost. Reasonable, community-sensitive development of this property has been delayed over 13 years in the course of administration of land-use laws. But, miraculous to report, grading, street and public utilities work is now nearly finished, and significant other construction work is now under way on the property for an authorized development into 32 houses interspersed with large open areas. Mutual Savings plans to make the development first-rate in every respect, and unique in the quality of its landscaping.

The buried value in real estate is limited by the small number of houses allowed (32) and by the fact that only about half of such houses will have a significant ocean view. Additional limitation will come from prospective high cost of private streets, sewage and utility improvements and connections, landscaping, and non-standardized, environmentally sensitive adaptation of housing to the site. Also, various charges and burdens, including heavy archaeological obligations imposed by governmental bodies, will drastically reduce our potential recovery from what it would have been had the zoning and development climate of the early 1970s continued into the present era. We have "given" a very large fraction of the value of our land to the County of Santa Barbara in exchange for permission to use it at all. In California these days such results are common, particularly in coastal areas.

The savings and loan association described in the foregoing paragraphs, quite different from most other associations for a long time, added a significant new abnormality during 1988. Mutual Savings increased its position in preferred stock of Federal Home Loan Mortgage Corporation (widely known as "Freddie Mac") to 2,400,000 when-issued shares. This is 4% of the total shares outstanding, the legal limit for any one holder. As this letter is written, all of these 2,400,000 shares have been issued and paid for. Mutual Savings' average cost is $29.89 per share, compared to a price of $50.50 per share in trading on the New York Stock Exchange at the end of 1988. Thus, based on 1988 yearend trading prices, Mutual Savings had an unrealized pre-tax profit in Freddie Mac shares of about $49.5 million. At current tax rates the potential after-tax profit is about $29.2 million, or $4.10 per Wesco share outstanding.

Freddie Mac is a hybrid, run by a federal agency (the Federal Home Loan Bank Board), but now owned privately, largely by institutional investors. Freddie Mac supports housing primarily by purchasing housing mortgage loans for immediate transmutation into mortgage-backed securities that it guarantees and promptly sells. In the process Freddie Mac earns fees and "spreads" while avoiding most interest-rate-change risk. This is a much better business than that carried on by most (or indeed most of the top 10% of) savings and loan associations, as demonstrated by Freddie Mac's remarkable percentage returns earned on equity capital in recent years.

At Freddie Mac's current dividend rate ($1.60 per annum per share), Mutual Savings' pre-tax yield is only 5.35% on its $29.89 average cost per share. Post-tax, the dividend yield is only 4.4%. But Freddie Mac has a very creditable history of raising its earnings and dividend rate, thus contributing to increases in the market price of its stock. The market price increases because Freddie Mac's "preferred" stock in substance is equivalent to common stock. Here are figures for 1985-1989:

Year Ended 12/31:	Earnings per Share	Dividends per Share	Year-End Market Price per Share	Freddie Mac's Return Earned on all Average Equity
1985	$2.98	$ .53	$ 9.19	30.0%
1986	3.72	1.13	15.17	28.5
1987	4.53	1.10	12.13	28.2
1988	5.73	1.25	50.50	27.5
1989 (announced)	?	1.60	?	?

The above numbers are unusually good for a stock selling at only $50.50 per share at the end of 1988. We think the probable cause of substandard investor response is some combination of (1) lack of familiarity with Freddie Mac among investors and (2) fear that the federal officials who control Freddie Mac will mismanage it or not deal fairly with Freddie Mac's private owners, perhaps under pressure from Congress.

There is, of course, some risk that Freddie Mac will ruin its remarkable business by ignoring fiduciary duties to new private owners, or reducing credit standards, or making bets on the future course of interest rates. But we consider such outcomes unlikely. The tendency to consider them likely rests largely in those who think ill of federal officials because of the dramatic, multi-billion-dollar insolvency of FSLIC (the U.S. agency which insures depositor accounts in savings and loan associations). This reaction is natural as it becomes ever more clear that the final FSLIC insolvency was augmented by regulatory failure to intervene early to solve easily diagnosed problems which were getting worse at a rapid rate.

But FSLIC and Freddie Mac are two separate entities, and the circumstances affecting the business of each are radically different. As the world changed, the troubles of FSLIC had roughly the following history and causes:

(1) In its early decades, the savings and loan industry lived under a system ordained by legislation in the 1930s. Interest rates paid by both banks and

associations were fixed by law at low levels, but with (i) a deposit-attracting advantage of ¼% more per annum which could be paid by associations and (ii) tax advantages for associations, compared with banks. The interest rate controls were created to dampen competition in an effort to prevent recurrence of the widespread failure of deposit-taking institutions which had followed the aggressive banking practices of the 1920s. In return for the cartel-like advantages granted and federal deposit insurance, associations were required to concentrate assets in home lending and to be conservative in risking losses from nonrepayment of loans. The standard practice of associations was then to borrow short (by taking demand deposits) and to lend long (by making long-term mortgage loans at fixed rates). Associations lived on an approximate two-percentage-point "spread" between the mortgage interest rate and the mandated low interest rate on deposits.

(2) This system always had a built-in risk that interest rates would generally and sharply rise, in which case the government would be forced to raise interest rates on deposits in order to enable associations to hold deposits. Then associations would be squeezed into losses because they were hooked by contract to fixed interest rates on old mortgages. But associations accommodated this risk, during periods of low inflation and slowly rising, government-fixed interest rates on deposits, by continuously "growing their way" out of profit-margin trouble. Associations simply "averaged up" the rate of interest on the whole mortgage portfolio by making ever larger amounts of new mortgage loans at higher interest rates. The necessary continuous growth, despite mandated low interest rates for savers, was made possible, of course, by the ¼% per annum deposit-attracting rate advantage possessed by associations. The system contained much wise and constructive cynicism, akin to that of the country's founding fathers. The system's creators wanted associations not to cause losses to FSLIC, the federal deposit-insurer, while helping the citizenry by favoring housing. So, knowing like Ben Franklin that "it is hard for an empty sack to stand upright," the creators simply gave associations significant competitive and tax advantages that made it easy for executives to do well while doing right. Also, because the creators admired "cooperative," workers'-self-help models and, looking back at the excesses of the 1920s, feared losses from capitalistic ambition more than they feared inefficiency from a more socialized process, all federally-chartered and most state-chartered associations were "mutual" institutions. Such institutions are "owned" by depositors and are therefore not capable of making any shareholder rich. In the early decades, this system, relying on carrot as well as stick, was, like the FHA, one of the most successful systems in U.S. history. It did a world of good at a trifling cost.

(3) Naturally, the few state-chartered, shareholder-owned associations (including Mutual Savings, which was "mutual" in name only) in due course became more aggressive than their "mutual" brethren and used their government-mandated competitive advantage to make their shareholders rich. This process was aided by their emphasizing high-yielding tract-housing loans in the

faster-growing parts of the country during a long boom. And envy plus logic then caused many "conversions" of formerly "mutual" associations to shareholder ownership, which, featuring different incentives, increased managements' proclivity to endure risk in the hope of above-normal reward. The heavy-risk-taking attitude finally spread throughout a large percentage of the savings and loan industry, including formerly conservative "mutual" institutions that remained "mutual" institutions.

(4) But, eventually, the tendencies of government to escalate currency debasement and of interest rates to rise sharply with sharp inflation combined to reduce the prosperity of the savings and loan industry, now structured more to produce extra profit when much went well than to prevent loss when much went wrong. As interest rates rose, even associations holding only high-grade, long-term, fixed-rate mortgages suffered large losses. Most gamier associations became hopelessly insolvent.

(5) In this new high-interest-rate environment, it proved impossible for most associations to "grow their way" out of trouble. Suddenly, the former bank and association duopoly faced new competition from "money market funds" that paid higher interest and also provided check-writing privileges, as well as from U.S. Treasury obligations that were more conveniently available. Not only could deposits not be increased; they could not be kept from shrinking.

(6) To prevent continuation of deposit outflows, which then tended to cripple housing, legislators decontrolled interest rates on all savings accounts. Next, after an irrational delay, the legislators allowed housing lending at interest rates that fluctuated with the market, a wise practice long standard in England. Even so, many associations remained insolvent "basket cases," because interest rates that had ratcheted upward on liabilities were matched against fixed and outdated rates on assets. Less impaired but still solvent associations had difficulty maintaining adequate equity capital without the "edge" possessed by the industry in its early years.

(7) In this period of trouble it also seemed logical to Congress and state legislatures, responding to non-apposite use of "free-market" labels and requests from savings and loan operators, to try to relieve the financial pressure by "helping" associations make more money. The method used was revision of investment rules for associations so that they could attempt to widen "spreads" by engaging in much more risky and difficult-to-manage deployments of assets that promised high yields if everything worked right. Deposit insurance was retained.

(8) But the coexistence of deposit insurance, liberalized asset deployment rules, and uncontrolled rates of interest which could be paid to savers had terrible consequences. The new system (despite minor impediments from some new anti-growth rules) enabled almost any association, even if small and remote and run by a crook or fool, to expand fast and almost without limit. When any association could use the government's credit and also promise to pay as high an interest rate as was required to bring in any desired amount of savings, the only

remaining limitation on size was the requirement that a small percentage of savings be matched with net worth. This was not much of a problem for growth-minded associations. The government, accommodatingly, *reduced* the percentage of net worth required. And when, after this help, growth was so great that more net worth was required to meet the relaxed general standard, such net worth could easily be provided, on paper, for a long time during expansion. After all, it is child's play to make any bank or savings and loan association report high profits for a while, thereby rapidly augmenting reported net worth, by making loans (or other asset deployments) providing both (i) high initial interest or profit accruals and (ii) probable high ultimate but delayed losses caused by the risks assumed. There are always real estate operators willing to sign any sort of promise or make any sort of projection in exchange for cash. The real estate crowd is notoriously optimistic and also includes a significant fraction of people like those who caused Mark Twain to define a mine as "a hole in the ground owned by a liar." Also, good short-term results are often available, in modern times, from merely committing money to sound borrowers for a very long time at a fixed rate, thus substituting lethal risk from interest rate change for lethal risk imposed by bad credit quality. Using one or more of the short-term, high-profit-reporting strategies, many minor associations soon grew to gargantuan size, often paying stockbrokers (and other brokers) commissions to bring in the massive amounts of deposits desired. The practice of using brokers to gain deposits had a high correlation with later insolvencies.

(9) The new system included a "runaway-feedback mode," exactly what every wise engineer or businessman learns to dread. It could and did entice into inappropriate conduct not only those always prone to bad behavior but also some associations that had formerly been admirable but were now suffering from bad luck. Once you were a loser and insolvent, for any reason, and very likely doomed, the system still granted you an opportunity to risk as much you wished of the government's money (your money was gone) in some massive gamble, on interest rates or business outcome, that had a chance of returning you to health. And, if the first gamble didn't work, you could always "double up." Such were the "parlay" possibilities for losers.

The losers' "parlays" were, quite predictably, made much quicker to arrange and much grander in scope by the availability of brokers who were paid to solicit government-insured deposits at above-normal interest rates (not a hard sale). The result was right out of *Alice in Wonderland.* For perhaps the first time in the history of regulation of deposit-taking institutions, the government (in the wry words of John Liscio of *Barron's*) was creating widespread "runs of money *into* small problem institutions and in the process turning them into big problem institutions."

For initial winners, shrewd or lucky in making risky investments, the "parlay" possibilities were immensely better. One instant-centimillionaire savings-and-loan family tried to gild the lily under such winning circumstances. The association involved proposed payment to a family executive of total compensa-

tion pushing $10 million per year. Then, after government regulators objected, the family satisfied itself with ordinary compensation (including bonus and special retirement contribution) of a mere $5 million or so. But the reduced ordinary compensation was supplemented by a lion's share of a huge new "incentive" to pay attention to business. Executives were granted rights to buy at attractive prices options or other securities of "junk bond" issuers which were available to the association at those attractive prices only in return for purchase of "junk bonds". ("Junk bonds" are bonds with high interest rates and grossly substandard credit backing that banks are pretty well forbidden to buy under their less permissive regulatory system. In recent years a large proportion of "junk bonds" were issued to help finance highly leveraged acquisitions and restructurings of corporations fearing or suffering from "raids" by hostile-takeover artists. Current practice is for deposit-insured banks to finance the most secured portion of massive corporate debt, which portion is maximized to a point which makes bank regulators sullen and fretful but not mutinous. Then some deposit-insured associations [and others] take loan positions so junior to many layers of senior debt [including but not limited to debt to banks] that language is strained when one calls them "loan positions." This anomaly in the total regulation of insured institutions is made possible [along with many other anomalies] by the division of total regulation into four systems [state and federal systems for both associations and banks] with some systems further subdivided to provide additional Balkanization.)

Such extraordinary success, in turn, had runaway-feedback possibilities of its own as examples of "parlayed" success became more widely known and envied, an enlightenment aided by brokers earning commissions or "spreads" by selling risky investments. In many cases, the end of the rapidly spreading winner's "parlay" game has not yet come. All we know is that the early phases look like many a speculative bubble which, in due course, was followed by a big bust.

There were other important consequences of the "parlay" games made possible by coexistence of decontrol and deposit insurance. The high interest rates promised by associations trying to "grow their way" out of trouble, or bent on instant-centimillionaire glory, tended to "bid up" the prices paid for savings by less ambitious associations in the would-be-conservative category. These institutions were therefore almost forced to consider high-rate, high-risk assets, so that they might have some chance of obtaining a moderate margin over costs. And thus was born the suggestion of a new sort of Gresham's law for deposit-insured, unlimited-interest-rate banking: "Bad lending drives out good."

The basic problem underlying this new form of Gresham's law may be impossible to solve, given the probable legislative premises that virtually unlimited deposit insurance, uncontrolled interest rates, wide discretion in deploying assets, and long grace periods when trouble comes, are each sacred. The problem is grounded deep in the nature of things, in the principle that in a complex system you can never "do merely one thing." When one variable is

maximized other variables often get minimized in an undesired way. In this case, in making money ultra-easy for everyone to get and invest in any amount and way desired, thus maximizing the availability of investable money, Congress changed the savings and loan system in a way that made it harder for associations to reloan the money safely at interest rates that covered costs. Congress thus minimized the opportunities for earning profits safely. As Garrett Hardin, the biologist, (or perhaps George Stigler, the economist) might say: "How could it be otherwise?" At any rate, the result as we observe it seems to be, roughly, that every form of savings and loan operation that is safe and simple, so that ordinary executives can manage it, avoiding both all net interest-rate-change risk and all net credit risk, will provide no net profit. Therefore every association that wishes to continue to exist is forced either to be remarkably prescient or to endure some combination of net credit risk and net interest-rate-change risk. This, in turn, makes normal earnings at strong associations like those of an earthquake insurer in a year when there is no earthquake. (Remember, upward fluctuations in interest rates on modern home loans are typically "capped" a mere 2½ percentage points over the mortgage interest rate prevailing when the loans were made.) Also, weak associations, guided by the less able, less honest, or less lucky, after exhausting shareholders' equity, tend to cause big losses to the government agency which insures savings accounts. These losses may exceed resources provided by deposit-insurance premiums.

Indeed, a government agency that tries to depend on 100% of its thinly capitalized deposit-insurance patrons being of above-average ability in unrestricted asset management, unrestricted in scale, would be "bonkers" not to expect large insurance losses. The system we now have is not "free market" economics. It is non-economics.

[At this point it is logical to inquire: If the foregoing reasoning is correct, why doesn't it apply to banks and why is the FDIC, which insures bank deposits, now in so much better shape than FSLIC? We think the answers are (i) that the fundamental reasoning does apply to banks, and we note that irresponsible bank lending, bank losses and FDIC losses all escalated dramatically after the installation of unlimited interest rates in a banking system already containing deposit insurance, and (ii) that the FDIC losses are, so far, lower than FSLIC losses for reasons including the following:

(a) the profit-shortage pressure has been lower at banks because of favorable momentum effects from the past, particularly including the banks' long monopoly in checking accounts, difficulties faced by would-be new entrants into banking, and traditional bank avoidance, through continuous repricing of loans, of most risk from interest rate change; and

(b) there is much tougher regulation, including better domestic-asset-quality controls, under the bank regulatory apparatus.

The second factor is particularly important. Tougher regulation clearly limits damage to the deposit-insurer. Indeed, if the toughness of bank regulation could be doubled and redoubled, so that it closed banks summarily when liquidating

value of equity was impaired but not exhausted, like the clearing system of a stock or commodity exchange, little would remain of expectancy of deposit-insurer loss from idiosyncratic high risk taking. It does not follow, however, that banks, even under such toughened regulation, would refrain from forms of high risk taking which became so conventional that trouble, if it came, would sink everyone at once. Under such circumstances, the regulated have a tendency to appraise regulatory threat as a paper tiger. Banking institutions (perhaps wisely) believe that the regulator which must close all banks will close none. Something like this has already occurred with respect to unwise foreign lending, where the regulatory response would, very likely, have been much tougher if only one big bank had been involved. Instead, with virtually all big banks threatened by huge holdings of dubious foreign loans, bank regulators are now much tougher on domestic loans worth 70¢ on the dollar than on foreign loans worth 40¢ on the dollar.]

(10) All of the foregoing happened to coincide with a general nationwide increase in wheeler-dealer activity, often with a fraud component. In this environment the new system attracted precisely the wrong sort of people into the savings and loan business as if designed for this purpose. It would have been hard to invent a system more irresponsible than the one that allowed any half-plausible group to control a savings and loan charter carrying the right to use the government's credit in the prompt attraction of multiple millions, or even billions. This was the financial equivalent of distributing free machine guns in cocaine alley, and many billions of dollars of fraud losses naturally followed.

(11) There also was a grand collapse in oil prices, creating the worst depression since the 1930s in oil-production-dependent areas, which caused many conservative home loans to go into default. Thus, FSLIC would have suffered large (but probably not lethal) losses even if inflation and legislators had never changed the savings and loan system.

(12) To be sure, even under the new system some possibilities remained for regulators or accountants to stop some FSLIC hemorrhages earlier than they actually did. But the accountants were selected and paid by the associations and had professional loyalties to clients as well as concepts. They were understandably loath to enforce death sentences until the negative aspects of complex situations became abundantly clear. And the regulators were overwhelmed by horror cases, being suddenly given the working conditions and triage problems of a M.A.S.H. unit, while receiving modest salaries. Moreover, the medical analogy fits when stretched further. FSLIC was not allowed by Congress to take much appropriate early corrective action. Just like certain savings and loan managements, Congress did not want to face the consequences — for instance, increased taxes — of honest bookkeeping and rational action. Indeed, many legislators intervened directly with the Federal Home Loan Bank system to protect particular fools or crooks, or merely unlucky savings and loan operators, from unpleasant consequences of insolvency. Thus FSLIC was not only like a doctor working under M.A.S.H.-unit conditions but also like such a doctor

forbidden to cause new pain, however brief, or make any blood transfusions (as distinguished from promises regarding future blood transfusions).

(13) The final result for FSLIC could easily be a loss of over $100 billion in a continuously unfolding financial mess that is among the greatest in U.S. history. Even some recently "rescued" associations, with new owners, are likely to cause new FSLIC losses at some later time — losses caused by the speculative temperaments of new managements attracted by loose asset-deployment rules.

While the Federal Home Loan Bank Board failed to prevent the insolvency of FSLIC, that insolvency was probably unpreventable, given its macroeconomic origin and subsequent conduct of legislators. FSLIC's "rescues," although imperfect, were probably as wise as could be expected under M.A.S.H.-unit conditions with no new blood available. There is an O. Henry short story in which God treats as a false arrest the bringing before Him of a miscreant young woman and sends the Heavenly Policeman back to bring in the real culprit, the neglectful father who raised her wrong. So also with the FSLIC mess. The important miscreants are not the crooks and fools who are always with us or the overburdened industry regulators. The real culprits are the ignorant, self-absorbed industry executives and state and federal legislators who should have known better than to let the system be crafted as it was. They also should have acted earlier to correct obvious errors, instead of becoming accessories after the fact.

In retrospect, it is clear that some of the very worst behavior of all, in the years when the FSLIC mess was created, was that of the United States League of Savings Institutions. The League combined a blind loyalty to silly ideas with a blind loyalty to member associations — a loyalty which usually treated the admirable and the despicable as if they were just the same. Acting with such "loyalty to a fault", the League was an effective foe of proper regulatory and legislative response. We are ashamed to report that during the whole period Mutual Savings paid its League dues promptly and voiced little objection to League conduct. This paragraph is a minor effort at atonement.

By silence we acquiesced wrongly as the League took antisocial positions which it incorrectly believed consistent with the long-term interest of the savings and loan industry. Our future behavior will be a little better: If the League does not act more responsibly in the future, Mutual Savings will resign.

It does not follow, we think, from FSLIC's troubles that federal controllers are likely to ruin Freddie Mac. FSLIC was very sick from causes outside the regulators' control, whereas Freddie Mac is flourishing. And Congress, better later than never, is now plainly chary of further loosening, and in fact desires to tighten, asset quality standards in the savings and loan industry and its regulatory apparatus.

Freddie Mac is now regarded in the mortgage, mortgage-securities and debt-issuing markets as a virtually risk-free government agency, even though its obligations are not technically backed by the full faith and credit of the United States. With this enormous advantage, Freddie Mac's controllers can almost always get socially constructive and financially rewarding results, provided they refrain from taking

significant risk of ruining Freddie Mac's credit. The annual dividend to private owners is peanuts, a small fraction of 1%, compared to the financing Freddie Mac provides to buyers of housing. The need for the dividend's safety and growth disciplines the system in exactly the right way. There is no reason to change course. Moreover, the right course, involving continued tough credit standards, has been clearly demonstrated by the recent terrible home loan experience in oil-production-dependent areas. Conventionally-sound home loans then went sour in massive quantities, despite having been made by wise and honorable lenders to home buyers with good jobs and loan-payment histories who made substantial down payments. Such experience reinforces the margin-of-safety principle required of highly leveraged institutions that guarantee credit. Just as bank credit standards remained sound for a long time after the horrors of the 1930s, home lending standards enforced by Freddie Mac may remain sound for a long time after the good-home-loan losses of the 1980s. If so, and if interest-rate-change risk is scrupulously minimized, Freddie Mac stock could be a good long-term investment for Mutual Savings.

Our discussion of reasoning regarding investment in Freddie Mac is an anomaly within the Berkshire Hathaway group. Normally, we do not disclose such reasoning. We fear bad effects on future investment buying or investment selling. (We also avoid display of our frequent mental inadequacies, but that is not the reason for the policy.) We depart from usual practice only because we have acquired a full investment position and we do not anticipate an increase in the legal limit which prevents us from buying more stock of Freddie Mac. Under these conditions, we are all for disclosure. But we are *not* recommending that Wesco shareholders purchase Freddie Mac stock. We never want to encourage Wesco shareholders to copy Wesco investments in their own personal accounts.

The first attempt at resolution by the federal government of the FSLIC insolvency will be made when new laws are enacted in 1989. The new laws will probably contain a combination of elements selected from the following list:

(1) sharp increase in deposit-insurance premiums payable to FSLIC;

(2) higher equity capital requirements for associations, with no credit for intangibles, and with prompt asset reduction required when the equity-capital minimum is breached;

(3) drastic reduction in investment powers to limit risky assets (including "junk bonds"), plus close monitoring of risk-prone associations;

(4) strict limits on annual growth of savings deposits;

(5) bans on use of brokers to bring in deposits;

(6) tougher accounting standards, including more bans on "front-ending" into reported income of fees paid in exchange for long-term commitments;

(7) tougher, more summary close-out procedures for associations, including those that are impaired but not insolvent;

(8) more insulation of regulation and close-out cases from interference by individual members of Congress;

(9) changes in control of regulation within the federal bureaucracy, aimed at toughening of regulatory practice, including more concentration of resources on obvious high-risk cases;

(10) a moratorium on approvals of new savings and loan charters; and

(11) more override of state law by federal law.

All the foregoing, except sharply higher deposit-insurance premiums, would clearly tend to reduce future FSLIC losses and should, as a minimum, be included in any half-sensible 1989 attempt to fix FSLIC. Payment to FSLIC of sharply higher deposit-insurance premiums would provide mixed results. On the one hand, FSLIC would get new revenue to help discharge liability from foolish insurance practices in the past. On the other hand, it is not clear how much net new revenue would be available. Sharply higher deposit-insurance premiums would also increase future FSLIC losses by increasing pressure on associations to acquire higher-risk assets promising the higher yields necessary to cover higher premiums. If deposit-insurance premiums are increased by ¼% per annum on total liabilities (which could happen) it will sound trifling and not very threatening to solvency. But associations' net worth, where it exists, is not owned by the government and may be withdrawn by its owners from the savings and loan industry. And, ignoring revenue from assets matching net worth, many associations now look at net profits vs. total liabilities at the rate of ¼% per annum as an unattainable dream. After all, the associations face aggressive competing institutions which either have lower costs, like money-market funds (which do not pay deposit-insurance premiums), or have more experience in maximizing safe yields, like banks. Starting from this not-so-hot competitive position and seeking not-so-obvious ways to stretch yields by ¼% per annum, many associations would, almost surely, be pressed into significant incremental losses. Others would quit the savings and loan business because of below-market returns being earned on shareholders' equity, and any equity capital withdrawn from the system would no longer "buffer" FSLIC against losses.

The would-be FSLIC fixers, as they set increased deposit-insurance premiums, will face the same basic question faced by a keeper of sheep. But, unlike the sheepkeeper, the government lacks knowledge to guide prediction of the point at which additional closeness of shearing will be contrary to the interests of the shearer. This leaves an important question: When you don't know for sure what the sheep can stand, how much safety margin do you leave before you set the shears, shear the whole herd, and send it forth to fare as it will?

The politics of the current scene seem to us to create more wishful thinking than sound thinking. We do not believe that the legislation adopted in 1989 will be likely to prevent recurrence of big trouble at FSLIC.

First, consider again the record of our modern legislators, the would-be FSLIC fixers. They started with a system designed to limit association insolvencies by both:

(1) protecting associations from full competition (a brutal force in a fungible commodity business, with money being the ultimate fungible commodity) and full taxes; and

(2) requiring associations to deploy assets in a very low-risk way.

Despite noting that this combination of carrot and stick kept the donkey under reasonable control for a long time, as it was designed to do after the insolvencies which followed excesses in the 1920s, the modern legislators actually removed the stick from the loss-control system in an attempt to compensate for the loss of the carrot. They also neglected, for a considerable period after interest rates of liabilities were unleashed, the obvious need to allow floating interest rates on home loan assets. And they acted, while they did this, as if they preferred to entice new thieves and megalomaniacs into coverage by federal deposit insurance and also to expand, as fast as possible, the operations of thieves and megalomaniacs already insured. Then, as FSLIC losses mounted, $10 billion or so at a time, the legislators delayed, and delayed, while going along with almost every form of foolish, paper-it-over expediency. And now, finally, we hear many cries for scapegoats in the "any one but me" category. We hear almost no cries for re-examination of assumptions (including re-examination in the form of (i) study of savings and loan systems which have worked better, like England's and (ii) consideration of alternatives such as forcing the private pension system, a huge savings pool which still possesses the carrot of tax exemption and can better bear interest rate crunches, to commit a share of assets to home loans, instead of high-turnover stock trading and the super-leveraging of corporate America, and (iii) consideration of other more extreme alternatives which fit modern facts). Instead, the first proposal, meeting tacit acceptance, is that any federal fix must qualify for mickey-mouse, off-budget accounting which will increase ultimate federal cost. This is not a fixing record which creates confidence in the fixers.

Second, consider the difficulty of the problem faced. As suggested earlier, that problem may well be a "lalapaloosa" which would not yield to the efforts of fixers much better than those we have. When you mix certain elements in a certain way you get sulfuric acid, wish it or not, and there are similar "impotency principles" in microeconomic systems. Under modern conditions it is quite conceivably impossible to create a deposit-insured savings and loan system, successful over the long term, which includes all the elements (for instance "capped" interest rates for borrowers in long-term loans) that a politically sensitive body will want to preserve. Thus the legislative fix attempted in 1989 may be only a more sophisticated version of the attempt of the rustic legislator, aiming at facilitation of education, who proposed a law rounding Pi to an even three. The derision of this example is aimed not so much at our legislators as at the normal working of the human mind. In the presence of complexity the ability to unlearn a once-successful idea is seldom found. Max Planck, the Nobel laureate, noted that even in physics, wherein the ablest of mankind are sworn as their highest duty to improve ideas to fit facts, you never really changed the minds of most of the old professors. Instead, the wide acceptance of correct new ideas had to wait for new professors who had less to unlearn.

Our views are that the problem faced is hard and that everyone has "unlearning difficulty." These views, of course, may have been shaped by our own thinking record. If the problem is not difficult, and if unlearning is easy, we would have

difficulty excusing ourselves for the clobbering Mutual Savings took from interest rate change in the early 1980s.

If our predictions are right, Wesco shareholders can pretty well count on Mutual Savings being harmed not only in 1989 but also at a second and later time. In each case we will face both new deposit-insurance costs and reductions of investment powers caused by insolvencies of a type Mutual Savings never got near.

As legislative changes are made Mutual Savings is likely to be hurt by all three of the following:

(1) wise changes in laws;

(2) unwise changes caused by the problems being more difficult than contentious legislative bodies are able or willing to think through; and

(3) unwise changes caused by vindictive legislative reaction to the size of the mess.

We fear changes in the last category because we so often see verifications of the iron prediction (roughly recalled) of the Victorian prime minister: "Those who will not face improvements because they are changes will face changes that are not improvements."

At least as we operate it, Mutual Savings, ex its investment in Freddie Mac, continues to have mediocre long-term prospects.

Precision Steel

The businesses of Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, contributed $3,167,000 to normal net operating income in 1988, up 29% compared with $2,450,000 in 1987. The increase in 1988 profit occurred in spite of a small decline in pounds of product sold. Revenues were up 14% to $62,694,000.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1988 continued to provide an extraordinary return.

The good financial results have an underlying reason, although not one strong enough to cause the results achieved in the absence of superb management. Precision Steel's businesses, despite their mundane nomenclature, are steps advanced on the quality scale from mere commodity-type businesses. Many customers of Precision Steel, needing dependable supply on short notice of specialized grades of high-quality, cold-rolled strip steel, reasonable prices, technical excellence in cutting to order, and remembrance when supplies are short, rightly believe that they have no fully comparable alternative in Precision Steel's market area. Indeed, many customers at locations remote from Chicago (for instance, Los Angeles) seek out Precision Steel's service.

It is not common that steel warehouses have results like Precision Steel's, even in a generally good year like 1988. What we have watched under David Hillstrom's leadership is boring, repetitive excellence, year after year. We love to see it and to be associated with him.

Wesco-Financial Insurance Company

A new business was added to the Wesco group in 1985, in co-venture with Wesco's 80% owner and ultimate parent corporation, Berkshire Hathaway Inc.

With the enthusiastic approval of all Wesco's directors, including substantial Wesco shareholders in the Peters and Caspers families, without whose approval such action would not have been taken, Wesco in 1985 invested $45 million in cash equivalents in a newly organized, wholly owned insurance company, Wesco-Financial Insurance Company ("Wes-FIC"). Another $45 million was invested in 1986 and 1987.

The new subsidiary, Wes-FIC, has reinsured, through another Berkshire Hathaway insurance company subsidiary as intermediary-without-profit, 2% of the entire book of insurance business of the long-established Fireman's Fund Corp. (listed on the NYSE). Wes-FIC thereby assumed the benefits and burdens of Fireman's Fund's prices, costs and losses under a contract covering all insurance premiums earned by Fireman's Fund during a four-year period commencing September 1, 1985. The arrangement puts Wes-FIC in almost exactly the position it would have been in if it, instead of Fireman's Fund, had directly written 2% of the business. Differences in results should occur only from the investment side of insurance, as Wes-FIC, instead of Fireman's Fund, invests funds from "float" generated. Wes-FIC's share of premiums earned in 1988 exceeded $62 million.

Wes-FIC in 1988 began to write direct business, as distinguished from reinsurance. It is now licensed in Nebraska, Utah and Iowa, but it wrote only $412,000 in direct premiums, all surplus lines coverage (permitted for non-admitted insurers) in Alabama. Earned direct premiums were $108,000.

Wes-FIC's "normal" net income for 1988 was $12,094,000, versus $9,459,000 for 1987. The net "normal" income figures excluded securities gains, net of income taxes, of $6,071,000 (including $4,836,000 realized on sale of Wes-FIC's 9% equity interest in Bowery Savings Bank) in 1988, compared with only $9,000 in securities gains in 1987. These items are reported as "Net Gains on Sales of Securities," below. Wes-FIC's net income benefitted by about $260,000 in 1988, versus $1 million in 1987, because of an unusual adjustment to its income tax provision caused by the Tax Reform Act of 1986.

It is in the nature of even the finest casualty insurance businesses that in keeping their accounts they must estimate and deduct all future costs and losses from premiums already earned. Uncertainties inherent in this undertaking make financial statements more mere "best honest guesses" than is typically the case with accounts of non-insurance-writing corporations. And the reinsurance portion of the casualty insurance business, because it contains one or more extra links in the loss-reporting chain, usually creates more accounting uncertainty than the non-reinsurance portion. Wesco shareholders should remain aware, not only of the inherent imperfections of Wes-FIC's accounting, but also of the inherent cyclicality of its business.

Wesco continues to expect a reasonable return on its investment over the four years of the Fireman's Fund reinsurance contract. However, the Fireman's Fund contract ends with August in 1989, which will leave Wes-FIC with a "longage" of

capital and a shortage of good insurance business. This is not a desired position, but there are worse ones.

All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, increased to $3,609,000 in 1988 from $1,808,000 in 1987. Sources were (1) rents ($2,436,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant) and (2) interest and dividends from cash equivalents and marketable securities held by Precision Steel and its subsidiaries and at the parent company level.

Net Gains On Sales Of Securities

Wesco's aggregate net gains on sales of securities, combined, after income taxes, increased to $6,525,000 in 1988 from $1,208,000 in 1987. As noted above, $6,071,000 of these gains were realized in the Wes-FIC insurance subsidiary.

Salomon Inc

On October 1, 1987 Wesco and certain of its wholly owned subsidiaries purchased 100,000 newly issued shares of Series A Cumulative Convertible Preferred Stock, without par value, of Salomon Inc ("Salomon"), at a cost of $100 million. Salomon's primary business is transacted by its subsidiary, Salomon Brothers, a leading securities firm. Our investment was part of a $700 million transaction in which other subsidiaries of Berkshire Hathaway Inc., Wesco's parent, invested $600 million. Principal terms of the transaction included the following: (1) the preferred stock pays dividends at the annual rate of 9%; (2) each preferred share, purchased at a cost of $1,000, will be convertible into 26.31579 shares of Salomon common stock on or after October 31, 1990, or earlier if certain extraordinary events occur; and (3) the preferred stock is subject to mandatory redemption provisions requiring the retirement, at $1,000 per share plus accrued dividends, of 20% of the issue on each October 31, beginning in 1995, so long as any shares of preferred stock remain outstanding.

At the stated conversion price of the preferred stock, a profit (subject to certain procedural requirements) will be realizable whenever, after October 31, 1990, the common stock of Salomon (listed NYSE) trades at over $38 per share. At the time of our commitment to buy the new preferred, the common stock of Salomon was selling in the low 30s. However, shortly after the ink dried on Wesco's new stock certificates, the October 19, 1987 "Black Monday" stock market crash occurred, which caused temporary but substantial operating losses plus a lowered credit rating at Salomon. Although Salomon, among securities firms, suffered only its rough share of the general debacle, its common stock at one time after the crash traded as low as $16⅝.

By the end of 1988 Salomon common stock was trading at $24⅛ after much constructive adjustment of Salomon's business to new conditions.

Salomon's credit as a potential source of preferred dividends and stock redemptions improved during its 1988 recovery, when generally available dividend rates on

preferred stock were roughly stable. With Wesco's preferred stock now one year shorter in contractual duration, and its conversion privilege enhanced in value during the year, we believe that the fair market value of Wesco's investment was somewhat in excess of its cost, and that the aggregate amount of any such excess was not material to Wesco, at December 31, 1988.

Berkshire Hathaway's Chairman, Warren Buffett, and the undersigned joined the board of Salomon on October 28, 1987, and are very pleased with the new association.

New Subsidiary

At the close of 1988, Wesco acquired 80% of the stock of New America Electrical Corporation ("New America Electric") for a price of $8,200,000. Of this price $7,165,000 was cash paid to a liquidating trust for the former shareholders of New America Fund and $1,035,000 was a ten-year, 10% note payable to Glen Mitchel, CEO of New America Electric, who retains the 20% of New America Electric not acquired by Wesco. The pattern of this acquisition is getting to be a common one within the Berkshire Hathaway group, where we are willing to be an 80% owner in many a business we would not be in if we did not admire and trust people who retain the other 20% and are expected to continue to operate the business, with little help and no hindrance from us.

Glen Mitchel is a long-time friend and trusted and admired business associate of the undersigned, Wesco's CEO. Indeed, because Wesco's CEO and his family owned more of New America Electric than Wesco, our whole transaction was approved by the Wesco board with the recommendation and participation of Warren Buffett, CEO and major shareholder of Berkshire Hathaway Inc., Wesco's parent company. Mr. Buffett had no financial interest in New America Electric, and he, plus Messrs. Munger and Mitchel, all believed that $10,250,000 was a fair valuation for 100% of New America Electric at yearend 1988.

New America Electric is a manufacturer of various electrical products including switchgear, circuit breakers, lighting ballasts and starters and electrical equipment for marinas and mobile home and recreational vehicle parks. Its facilities are in Orange County, California.

New America Electric has a present book net worth of about $6,400,000, including over $2,500,000 in cash, and a long history of earning high returns on capital, but with current earnings reduced by conditions approaching those of severe price war. Fortunately, New America Electric is a very low-cost producer. Its size is not material (in accounting parlance) to Wesco; so we have not yet determined future reporting practice. At a minimum, essential information will be discussed each year in the Annual Report's Letter to Shareholders.

This acquisition became available to Wesco because Glen Mitchel preferred minority (20%) ownership of a Berkshire Hathaway group subsidiary instead of dominant 30% ownership in New America Electric, with all other New America Electric stock pretty well scattered through a new public offering, which was the alternative offered. We will try to deserve Glen Mitchel's confidence.

Consolidated Balance Sheet and Related Discussion

Wesco's consolidated balance sheet (1) retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others and (2) reflects a continuing slow pace of acquisition of additional businesses because few are found available, despite constant search, at prices deemed rational from the standpoint of Wesco shareholders.

As indicated in the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate carrying value at December 31, 1988 by about $54 million, up significantly from about $6 million one year earlier. The consolidated aggregate market value of all marketable securities, including bonds and other fixed-income securities, exceeded aggregate carrying value by about $62 million. As earlier noted, about $57 million of this unrealized appreciation lies within the savings and loan subsidiary, and includes $49.5 million of appreciation in stock of Freddie Mac.

Wesco's Pasadena real estate, a full block (containing (1) about 125,000 first-class net rentable square feet, including Mutual Savings' space, in a modern office building, plus (2) an additional net rentable 34,000 square feet of economically marginal space in old buildings requiring expensive improvement), has a market value substantially in excess of carrying value, demonstrated by (1) mortgage debt ($4,751,000 at 9.25% fixed) against this real estate now exceeding its depreciated carrying value ($2,937,000) in Wesco's balance sheet at December 31, 1988, and (2) substantial current net cash flow (about $1 million per year) to Wesco after debt service on the mortgage. The modern office building is 99% rented, despite a glut of vacant office space in Pasadena. We charge just-below-standard rents and run the building as a sort of first-class club for tenants we admire. With these practices, a prime location and superior parking facilities, we anticipate future increases in cash flow, but at no better rate than the rate of inflation.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity, however, requires patience, as suitable opportunities are seldom present.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and insurance subsidiaries and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in very few places. Through this practice of concentration of investments, better understanding is sought with respect to the few decisions made.

The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 10% in 1986-88, was dependent to a significant extent on securities gains, irregular by nature.

The considerable, and higher than desired, liquidity of Wesco's consolidated financial position as this is written does not result from our forecast that business

conditions are about to worsen, or that interest rates are about to rise, or that common stock prices are about to fall. Wesco's condition results, instead, from our simply not finding opportunities for more aggressive use of capital with which we are comfortable.

Wesco continues to try more to profit from always remembering the obvious than from grasping the esoteric. Such an approach, while it has worked fairly well on average in the past and will probably work fairly well over the long-term future, is bound to encounter periods of dullness and disadvantage as it limits action.

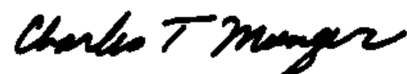
Moreover, our approach continues to be applied to no great base position. Wesco has only a tiny fraction of its total intrinsic value in businesses with enough commercial advantage in place to assure permanent high future returns on capital employed. In contrast, Berkshire Hathaway Inc., Wesco's parent corporation, has a larger proportion of its intrinsic value in durable high-return businesses.

Some historical explanation for the current situation should be repeated here. When Wesco's parent corporation acquired control, Wesco's activities were almost entirely limited to holding (1) some surplus cash, plus (2) a multi-branch savings and loan association which had many very long-term, fixed-rate mortgages, offset by interest-bearing demand deposits. The acquisition of this intrinsically disadvantageous position was unwisely made, alternative opportunities considered, because the acquirer (including the signer of this letter) was overly influenced by a price considered to be moderately below liquidating value. Under such circumstances, acquisitions have a way of producing, on average, for acquirers who are not quick-turn operators, low to moderate long-term results. This happens because any advantage from a starting "bargain" gets swamped by effects from change-resistant mediocrity in the purchased business. Such normal effects have not been completely avoided at Wesco, despite some successful activities, including a large gain in 1985 from an investment in General Foods.

A corporation like Wesco, with no significant proportion of intrinsic value in great businesses, continues to be like a tortoise in a race of hares. And, as we have plainly demonstrated, this particular tortoise is not very sprightly.

On January 26, 1989, Wesco increased its regular quarterly dividend from 18½ cents per share to 19½ cents per share, payable March 7, 1989, to shareholders of record as of the close of business on February 10, 1989.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.



Charles T. Munger
Chairman of the Board

February 24, 1989

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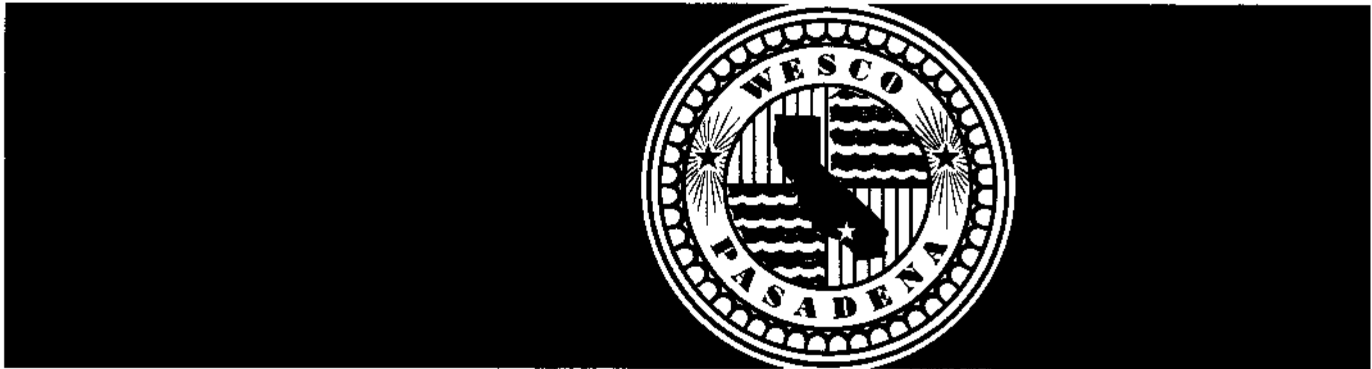


WESCO FINANCIAL CORPORATION

Annual Report 1989

Form 10-K Annual Report 1989

The 1989 Annual Report of Wesco Financial Corporation included the following letter to Wesco stockholders from the Chairman of the Company.

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" operating income (i.e., before all unusual operating income and all net gains from sales of securities) for the calendar year 1989 increased to $24,414,000 ($3.43 per share) from $23,564,000 ($3.31 per share) in the previous year.

Consolidated net income (i.e., after unusual operating items and all net gains from sales of securities) increased to $30,334,000 ($4.26 per share) from $30,089,000 ($4.22 per share) in the previous year.

Wesco has three major subsidiaries, Mutual Savings, in Pasadena, Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged principally in the reinsurance business, and Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended			
	December 31, 1989		December 31, 1988	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income of:				
Mutual Savings	$ 4,191	$ .59	$ 4,694	$ .66
Wesco-Financial Insurance business	14,276	2.00	12,094	1.70
Precision Steel's businesses	2,769	.39	3,167	.44
All other "normal" net operating income[2]	3,178	.45	3,609	.51
	24,414	3.43	23,564	3.31
Gain on sale of interest in Bowery Savings Bank	—	—	4,836	.68
Net gains on sales of marketable securities	5,920	.83	1,689	.23
Wesco consolidated net income	$30,334	$4.26	$30,089	$4.22

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings headquarters office building, primarily leased to outside tenants, interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries, and the electrical equipment manufacturing business, 80%-owned by Wesco since yearend 1988.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

Mutual Savings

Mutual Savings' "normal" net operating income of $4,191,000 in 1989 represented a decrease of 11% from the $4,694,000 figure the previous year.

The decrease in 1989 was primarily attributable to a less favorable interest rate "spread" as cost of holding savings increased more than yield on loans and investments.

As usual, these "normal-income" figures come from a decidedly abnormal savings and loan association.

Separate balance sheets of Mutual Savings at yearend 1988 and 1989 are set forth at the end of this annual report. They show (1) total savings accounts rising to $293 million from $289 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (near the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, and (4) a loan portfolio (mostly real estate mortgages) of about $154 million at the end of 1989, up slightly from $137 million at the end of 1988.

The loan portfolio at the end of 1989, although containing almost no risk of loss from defaults, bore an average interest rate of only 9.23%, probably near the lowest among U.S. savings and loan associations, but up moderately from 8.70% at the end of 1988. Because the loan portfolio is almost entirely made up of instruments of short maturity or bearing interest rates that adjust automatically with the market, there is now much less unrealized depreciation in the loan portfolio than the net unrealized appreciation in Mutual Savings' interest-bearing securities and public utility preferred stocks. That appreciation at December 31, 1989 was about $11.3 million.

While the "spread" between Mutual Savings' average interest rates paid on savings and received on loans remains too low to provide respectable profits, this "spread" improved again last year. Moreover, the disadvantage from inadequate "spread" has been reduced in each recent year by the effect of various forms of tax-advantaged investment, primarily preferred stock and municipal bonds. The negative side of this tax-advantaged antidote to inadequate interest rate margin on loans is the risk that preferred stock and municipal bonds, with their fixed yield and long life, will decline in value and not provide enough income to cover Mutual Savings' interest and other costs, if the general level of interest rates should sharply rise. In view of this risk, Mutual Savings' total commitment has been kept conservative, relative to the amount of its net worth.

Mutual Savings remains a "qualified thrift lender" under the old federal regulatory definition (which ends June 30, 1991) requiring 60% of assets in various housing-related categories. It plans to continue keeping substantially all loans receivable either with short expected lives or with interest rates that fluctuate with the market. All new variable-rate loans are "capped" at the 25% per annum level, which is over ten percentage points higher than the common 2½-points-over-market "cap" offered by competing associations. Naturally, to gain this extra protection from interest rate increase, Mutual Savings "pays" by (1) getting lower "spreads" over an interest rate index, and (2) not being able to make loans in amounts desired.

As pointed out in Note 10 to the accompanying financial statements, the book value of Wesco's equity in Mutual Savings ($48.9 million at December 31, 1989) overstates the amount realizable, after taxes, from sale or liquidation at book value. If all Mutual Savings' assets, net of liabilities, were to be sold for the $48.9 million reported as book value, the parent corporation would receive much less than $48.9 million after substantial income taxation imposed because about $47 million of what is designated shareholders' equity for accounting purposes is considered bad debt reserves for most tax purposes.

Mutual Savings has not only a buried value in unrealized appreciation of securities but also a buried value in real estate. The foreclosed property on hand (mostly 22 acres at or near the oceanfront in Santa Barbara, acquired in 1966) has become worth over a long holding period considerably more than its $8.4 million balance sheet carrying cost. Reasonable, community-sensitive development of this property has been delayed over 14 years in the course of administration of land-use laws. But, miraculous to report, eight houses, plus recreation facilities, are in various stages of completion on the property as part of an authorized development into 32 houses interspersed with large open areas. Mutual Savings plans to make the development first-rate in every respect, and unique in the quality of its landscaping.

The buried value in real estate is limited by the small number of houses allowed (32) and by the fact that only about half of such houses will have a significant ocean view. Additional limitation will come from high cost of private streets, sewage and utility improvements and connections, landscaping, and non-standardized, environmentally sensitive adaptation of housing to the site. Also, various charges and burdens, including heavy archaeological obligations imposed by governmental bodies, will drastically reduce our potential recovery from what it would have been had the zoning and development climate of the early 1970s continued into the present era. We have "given" a very large fraction of the value of our land to the County of Santa Barbara in exchange for permission to use it at all.

The savings and loan association described in the foregoing paragraphs, quite different from most other associations for a long time, added a significant new abnormality during 1988. Mutual Savings increased its position in stock of Federal Home Loan Mortgage Corporation (widely known as "Freddie Mac") to 2,400,000 shares. This is 4% of the total shares outstanding, the legal limit for any one holder at the time the shares were purchased. Mutual Savings' average cost is $29.89 per share, compared to a price of $67.12 per share in trading on the New York Stock Exchange at the end of 1989. Thus, based on 1989 yearend trading prices, Mutual Savings had an unrealized pre-tax profit in Freddie Mac shares of about $89.4 million. At current tax rates the potential after-tax profit is about $52.6 million, or $7.39 per Wesco share outstanding.

Freddie Mac, formerly created and long run by a federal agency (the Federal Home Loan Bank Board), is now owned privately, largely by institutional investors and is now governed by an independent board of directors. Freddie Mac supports housing primarily by purchasing housing mortgage loans for immediate transmutation into mortgage-backed securities that it guarantees and promptly sells. In the process Freddie Mac earns fees and "spreads" while avoiding most interest-rate-change risk. This is a much better business than that carried on by most (or indeed most of the top 10% of) savings and loan associations, as demonstrated by Freddie Mac's high percentage returns earned on equity capital in recent years. One ironic cause of the high returns is that this creation of federal regulators pays no deposit-insurance premiums as it replaces much of the former function of the savings and loan industry.

At Freddie Mac's current dividend rate ($1.60 per annum per share), Mutual Savings' pre-tax yield is only 5.35% on its $29.89 average cost per share. Post-tax, the dividend yield is only 4.4%, but this amounts to about 75% of the current after-tax yield from very high grade mortgages. Moreover, Freddie Mac has a very creditable history of avoiding significant loan losses and increasing its earnings and dividend rate, thus contributing to increases in the market price of its stock. Following are figures for 1985-1989:

Year Ended 12/31:	Earnings per Share	Dividends per Share	Year-End Market Price per Share	Freddie Mac's Return Earned on all Average Equity
1985	$2.98	$ .53	$ 9.19	30.0%
1986	3.72	1.13	15.17	28.5
1987	4.53	1.10	12.12	28.2
1988	5.73	1.25	50.50	27.5
1989	6.57	1.60	67.12	25.0

When Wesco's annual report went to press last year, Congress was midcourse in considering revisions to the savings and loan laws. But it was clear that associations were shortly to be "re-regulated" into some mode less likely to cause a fresh torrent of deposit-insurance losses, borne by taxpayers. Provoking that legislative action was a previous torrent of losses which now seems likely to exceed $150 billion. These losses were caused by a combination of (1) competitive pressure on the "spread" between interest paid and interest received put on associations and banks when federal deposit insurance is provided to entities free to pay any interest rates they wish in order to attract deposits, (2) loose asset deployment rules for associations, (3) admission and retention of crooks and fools as managers of associations without regulatory objection, (4) general real estate calamities in certain big regions, and (5) continuous irresponsible protection and enhancement of unsoundness by the savings and loan lobby and certain members of Congress beholden to the most despicable savings and loan operators.

The new laws, under the acronym FIRREA, were composed and enacted with a speed caused by congressional indignation. (A recent example of such indignation, employing remarkable comparisons, is provided by the words of Congressman Jim Leach: "[If certain allegations are true] Charles Keating is a financiopath of obscene proportions — the Reverend Jim Bakker of American commerce, given a license to steal by a bank board headed by the Neville Chamberlain of regulation — a cheerleader who saw little evil and thus spoke little truth.")

Mutual Savings modestly contributed to tough legislative action by resigning from the U.S. League of Savings Institutions, using a letter of resignation which drew widespread media attention despite its understated criticism. A copy of this letter of resignation is appended at the end of this letter to shareholders.

Mutual Savings, desiring to act responsibly, supported virtually all the law revisions made by FIRREA, even though many of them will hurt Mutual Savings' profits.

For example:

(1) In stages, by July 1, 1994, Mutual Savings (and its service corporation subsidiary) must dispose of:

(a) High-quality public utility preferred stocks, having tax-advantaged dividend rates averaging about 10.8% per annum, with a carrying value of $41.4 million at yearend 1989, and a market value then higher by about $8.7 million; and

(b) High-quality convertible preferred stock of Salomon Inc, bearing a tax-advantaged dividend rate of 9% per annum, with a carrying value of $26 million, believed to be below the amount which could be realized in the event of sale.

(2) In stages, by the same date, July 1, 1994, Mutual Savings must write down to zero, in computing net worth for regulatory purposes, its 2,400,000 shares of Freddie Mac, which

had a carrying value of $71.7 million at yearend 1989, and, as reported above, a market value then higher by about $89.4 million.

(3) All new asset commitments, fitting Mutual Savings' proclivities and tax position, are pretty well restricted to (a) housing loans (including indirect loans in the form of mortgage-backed securities) and (b) debt instruments of the U.S. Government or its agencies.

(4) In stages, designed to create compliance during a two-year period commencing July 1, 1991, Mutual Savings will have to increase "qualified thrift lender" assets by 10 percentage points to a 70%-of-assets level, using a new and more limited definition of such "qualified thrift lender" assets which, to our surprise, does not include Freddie Mac stock. If the new test had been in full effect at December 31, 1989, Mutual Savings would have complied by disposing of about $74 million of non-home-loan assets (including some cash equivalents) and placing the proceeds in home loans (including indirect home loans in the form of short-term mortgage-backed securities).

(5) Deposit-insurance premiums have been increased. Short term, Mutual Savings is protected by credits of a nonrecurring nature. But by the mid 1990s the new premium rates will reduce Mutual Savings' annual earning power by about $200,000 from the level which would have occurred if it were still paying at the 0.083%-of-deposits rate which was in effect for years, instead of the new rate of 0.23%. The adverse effect of the higher deposit insurance costs on percentage return on shareholders' equity is much lower at Mutual Savings than at almost all other associations, which suffer substantially. The cause of Mutual Savings' advantage is its much larger percentage of equity, compared to deposits. This is a "one-time" advantage related to one ratio; on an incremental dollar of savings Mutual Savings faces the same damage as everyone else.

These combined effects will reduce Mutual Savings' normal earning power. While conservatively operated, Mutual Savings has been scrambling through recent years in its own way, obtaining a modest success made possible largely by the wide variety of asset-deployment options available under pre-FIRREA law. Consequently, FIRREA will adversely affect Mutual Savings, however wise the new restrictions, public needs considered. Nevertheless, it is probable that Mutual Savings' normal earning power will not be much reduced in 1990 and 1991.

We predict this deferment of decline in normal earnings because:

(1) FIRREA's asset-mix effects are phased in, subject to wide regulatory discretion; and

(2) We anticipate that regulators will be wise enough to exercise their discretion to allow extra-strong associations, with easy-to-sell assets, the same forbearance which will be granted to weak associations with hard-to-sell assets.

If we prove wrong in our prediction about regulators, Mutual Savings' wisest alternative will probably be withdrawal from the savings and loan business and the related obligation to pay deposit-insurance premiums.

If, as seems likely, Mutual Savings stays in the savings and loan business, it will retain a business even more mediocre than before, with only two interesting near-term prospects:

(1) During the next few years, Mutual Savings is almost certain to make a pre-tax profit of a nonrecurring nature as it disposes of the Santa Barbara property it acquired through foreclosure in 1966; and

(2) Mutual Savings will retain prospects for gain from its Freddie Mac stock if, as anticipated, Freddie Mac pays ever-higher dividends and the price of the stock also rises.

Long term, Mutual Savings hopes to find within the savings and loan business some constructive, continuing role which is not dependent on either of the foregoing anticipated near-term prospects. Until the right long-term role is found, our policy is simply to "stagger through."

The FIRREA law revision, while greatly improving the savings and loan system from the taxpayers' point of view, took an approach which can fairly be described as "all stick and no carrot." This is no way to create felicity for the donkey, but we deserve our share of the beating because we were previously so passive in the presence of obvious error and evil. Moreover, the safety-enhancing features of the law revision fell short in one fundamental respect which leaves profits under pressure: banks and associations remain free, within wide limits, to attract government-insured deposits at any interest rate they wish, while they must resell the ultimate fungible commodity, the use of money, into a brutally competitive market. The resulting squeeze on interest-rate "spread" safely attainable, combined with normal competitive disadvantages of associations, leaves the average well-run association with a likely future which should not excite its owners.

The normal competitive disadvantages of the average association, compared with the average bank, now include the following: higher deposit-insurance costs, more confusing new regulation, and less experience and momentum in various important remunerative activities. As a result, even a superbly run conventional association, like the one owned by H. F. Ahmanson & Co., sells in the stock market at a much lower price-to-book-value ratio than a superbly run bank. And the average savings and loan branch office probably now offers more incremental value to an experienced bank than it provides to its present owner.

Moreover, the average association does not now compete only with banks. Also gathering "deposits" are the money-market funds which:

(1) pay no deposit-insurance premiums, saving 0.23% of deposits each year, compared to associations;

(2) are required to employ exactly no capital from profit-earning proprietors ("management companies" in fund parlance), while capital requirements for associations have been raised;

(3) have lower-cost regulation (from an understaffed SEC) than associations;

(4) maintain no expensive branch offices, although they provide check-writing privileges and accept frequent deposits, using fast, low-cost systems which are better adapted in many ways to the new order than the systems of the average association; and,

(5) as a result of all the foregoing advantages, have total annual costs (before proprietors' profits), as a percentage of assets, which are more than 50% lower than annual costs of the most efficient association.

Thus, the natural "almost-no-brainer," non-home-mortgage, deposit-gathering niche is now occupied by a competing, better-adapted new species. This leaves associations in roughly the position of the original rabbit-like mammals which lost ecological market share when the rabbit was introduced into Australia. The adjustable-home-mortgage niche may now provide a decent home for some large, extremely efficient loan originators like Home Savings, but, as we seem to say each year, we have not yet found for Mutual Savings a permanent lending niche which is attractive, as distinguished from bearable. In the mortgage business we thus constantly confirm Samuel Johnson's observation that: "Life is a state in which much is to be endured and little to be enjoyed."

Left in place in the revised savings and loan system is a significant (although much reduced) structural risk for the federal government as deposit insurer. Associations retain a considerable residue of temptation to act imprudently. The temptation, in response to the profit-pressure which is a natural consequence of the structure of the system, is the same one which caused troubles in the

past: the temptation to seek an acceptable interest rate "spread," not available any other way, by bearing undue risk from either (1) mismatched maturities of loans and deposits or (2) losses through defaults of a gamier class of borrowers willing to promise extra-high interest rates. It is almost impossible to have asset deployment controls so tough that a bank or association can't look good for a while (and give the appearance of justifying higher compensation of management) as it takes risks which will in due course destroy its owners' equity and also cause deposit insurance losses. The "all stick" method of control is much better than nothing, but it is far from ideal when it is the exclusive method for prevention of losses borne by the deposit insurer. In contrast, when, long ago, the federal deposit insurer had low losses, the savings and loan system used both carrots and stick, so that the average savings and loan operator could do well without exceptional luck or ability. (The carrots were very low income taxation plus interest-rate controls which reduced cost of holding deposits while giving an advantage over banks in attracting deposits.) We think the present, revised system continues to impose more risk than taxpayers should bear, with high deposit-insurance costs contributing to the risk as well as compensating for it.

Housing is now less assisted than before by the existence of savings and loan associations. An example of the drift away from housing assistance is provided by FIRREA's new restriction preventing large loans to any one house builder. The new requirement is that an association loan no more than 15% of owners' equity to one customer, with exceptions permitted up to 30% for adequately capitalized associations with good records. The new requirement would have greatly reduced the profits and housing contributions of Mutual Savings in its early days when it concentrated resources in development loans while trusting only a few house-builders. And the new requirement now has the same general effect. It will significantly restrict availability of house-building loans in many regions of the country. This result demonstrates the impossibility of revising a complex system without undesired "by-product" effects. The first law of ecology and the first law of legislation are one and the same: "You can never do merely one thing."

Of course, a "by-product" of law revision sometimes helps, instead of hurts, some participant in a market. New "risk-based" capital requirements under FIRREA have such an effect, as they give associations new incentives to transfer monies they otherwise would have earned to Freddie Mac, through exchange of mortgages for credit-enhanced, mortgage-backed securities. (Although the securities then provide less income, they help satisfy regulatory capital requirements, because the securities require less owners' equity to hold.) This income-transfer effect should help Mutual Savings, through its large shareholding position in Freddie Mac.

Precision Steel

The businesses of Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, contributed $2,769,000 to normal net operating income in 1989, down 13% compared with $3,167,000 in 1988. The decrease in 1989 profit occurred as pounds of product sold declined by 12%. Revenues were down less, by 5% to $59,440,000.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1989 continued to provide an extraordinary return on resources employed.

As we never tire of saying, the good financial results have an underlying reason, although not one strong enough to cause the results achieved in the absence of superb management. Precision Steel's businesses, despite their mundane nomenclature, are steps advanced on the quality scale from mere commodity-type businesses. Many customers of Precision Steel, needing dependable supply on short notice of specialized grades of high-quality, cold-rolled strip steel, reasonable prices, technical excellence in cutting to order, and remembrance when supplies are short, rightly believe that they have no fully comparable alternative in Precision Steel's market area. Indeed, many

customers at locations remote from Chicago (for instance, Los Angeles) seek out Precision Steel's service.

It is not common that steel warehouses have results like Precision Steel's. What we see, year after year, under David Hillstrom's leadership is boring, repetitive excellence as he remembers a basic catechism emphasizing service of the highest quality. We hope to be associated with him for a long time.

Wesco-Financial Insurance Company

A new business was added to the Wesco group in 1985, in co-venture with Wesco's 80% owner and ultimate parent corporation, Berkshire Hathaway Inc.

With the enthusiastic approval of all Wesco's directors, including substantial Wesco shareholders in the Peters and Caspers families, without whose approval such action would not have been taken, Wesco in 1985 invested $45 million in cash equivalents in a newly organized, wholly owned insurance company, Wesco-Financial Insurance Company ("Wes-FIC"). Another $58 million was invested in 1986, 1987 and 1989.

The new subsidiary, Wes-FIC, reinsured, through another Berkshire Hathaway insurance company subsidiary as intermediary-without-profit, 2% of the entire book of insurance business of the long-established Fireman's Fund Group. Wes-FIC thereby assumed the benefits and burdens of Fireman's Fund's prices, costs and losses under a contract covering all insurance premiums earned by Fireman's Fund during a four-year period ending August 31, 1989. The arrangement put Wes-FIC in almost exactly the position it would have been in if it, instead of Fireman's Fund, had directly written 2% of the business. Differences in results occurred only from the investment side of insurance, as Wes-FIC, instead of Fireman's Fund, invested funds from "float" generated. Wes-FIC's share of premiums earned in 1989, before contract termination, exceeded $37 million.

Upon contract termination, Wes-FIC returned to Fireman's Fund $15.6 million in unearned premiums, net of related ceding commissions, and retained assets of about $91 million offset by claims reserves which will be exhausted slowly over many future years. We regard the totality of Wesco's four-year participation in the Fireman's Fund reinsurance contract as having excellent prospects, all future claim payments considered. Wesco's ultimate parent corporation (and 80% owner) almost certainly did Wesco a favor in allowing Wesco's participation, as was planned at the time.

There was some good luck in the selection, years ago, of a termination date for the Fireman's Fund contract. The date, August 31, 1989, happened to be just before occurrence of both Hurricane Hugo and the San Francisco earthquake. There was some heavenly justice in this outcome, because Wes-FIC caught a share of hurricane losses within hours after the inception of the contract in 1985.

Wes-FIC in 1988 began to write direct business, as distinguished from reinsurance. It is now licensed in Nebraska, Utah and Iowa, but it wrote only $183,000 in direct premiums, almost all surplus lines coverage (permitted for non-admitted insurers) in Alabama. Earned direct premiums were $438,000.

Wes-FIC's "normal" net income for 1989 was $14,276,000, versus $12,094,000 for 1988. The net "normal" income figures excluded securities gains, net of income taxes, of $5,910,000 in 1989, compared with $6,071,000 (including $4,836,000 realized on sale of Wes-FIC's 9% equity interest in Bowery Savings Bank) in 1988. These items are reported as "Net Gains on Sales of Securities," below. Wes-FIC's net income benefitted by about $215,000 in 1989, versus $260,000 in 1988, because of an unusual adjustment to its income tax provision caused by the Tax Reform Act of 1986.

It is in the nature of even the finest casualty insurance businesses that in keeping their accounts they must estimate and deduct all future costs and losses from premiums already earned. Uncertainties inherent in this undertaking make financial statements more mere "best honest guesses" than is typically the case with accounts of non-insurance-writing corporations. And the reinsurance portion of the casualty insurance business, because it contains one or more extra links in the loss-reporting chain, usually creates more accounting uncertainty than the non-reinsurance portion. Wesco shareholders should remain aware of the inherent imperfections of Wes-FIC's accounting, based as it is on forecasts of outcomes in many future years.

Wes-FIC retains a "longage" of capital and a shortage of good insurance business. We see few present opportunities for sound expansion, but we expect more insurance writing in due course, made possible by fear that other insurers will become unable or unwilling to pay fair claims.

Effective January 1, 1990, Wes-FIC has begun to reinsure 50% of the book of insurance business (largely workers' compensation insurance) of Cypress Insurance Company, a wholly owned subsidiary of Berkshire Hathaway. Wes-FIC's share of premiums written is expected to approximate $8 million in 1990. We regard this reinsurance contract as worth having at Wesco, but it is not nearly as promising, per dollar of insurance written, as was the Fireman's Fund contract.

All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, decreased to $3,178,000 in 1989 from $3,609,000 in 1988. Sources were (1) rents ($2,518,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant), (2) interest and dividends from cash equivalents and marketable securities held outside the savings and loan and insurance subsidiaries, and (3) earnings of New America Electrical Corporation. The decrease in this "all other" component of earnings in 1989 resulted primarily from transfer of assets, with their related incomes, to Wesco's insurance subsidiary to augment its capital position.

Net Gains On Sales Of Securities

Wesco's aggregate net gains on sales of securities, combined, after income taxes, decreased to $5,920,000 in 1989 from $6,525,000 in 1988. As noted above, $5,910,000 of these gains were realized in the Wes-FIC insurance subsidiary in 1989, versus $6,071,000 realized in 1988.

Convertible Preferred Stock of Salomon Inc

On October 1, 1987 Wesco and certain of its wholly owned subsidiaries purchased 100,000 newly issued shares of Series A Cumulative Convertible Preferred Stock, without par value, of Salomon Inc ("Salomon"), at a cost of $100 million. Salomon's primary business is transacted by its subsidiary, Salomon Brothers, a leading securities firm. Our investment was part of a $700 million transaction in which other subsidiaries of Berkshire Hathaway Inc., Wesco's parent, invested $600 million. Principal terms of the transaction included the following: (1) the preferred stock pays dividends at the annual rate of 9%; (2) each preferred share, purchased at a cost of $1,000, will be convertible into 26.31579 shares of Salomon common stock on or after October 31, 1990, or earlier if certain extraordinary events occur; and (3) the preferred stock is subject to mandatory redemption provisions requiring the retirement, at $1,000 per share plus accrued dividends, of 20% of the issue on each October 31, beginning in 1995, so long as any shares of preferred stock remain outstanding.

At the stated conversion price of the preferred stock, a profit (subject to certain procedural requirements) will be realizable whenever, after October 31, 1990, the common stock of Salomon (listed on the New York Stock Exchange) trades at over $38 per share. At the time of our

commitment to buy the new preferred, the common stock of Salomon was selling in the low 30s. However, shortly after Wesco acquired its new stock certificates, the October 19, 1987 "Black Monday" stock market crash occurred, which caused temporary but substantial operating losses plus a lowered credit rating at Salomon. Although Salomon, among securities firms, suffered only its rough share of the general debacle, its common stock at one time after the crash traded as low as $16⅝.

At the end of 1989 Salomon common stock was trading at $23⅜, compared with $24⅛ at the end of 1988, after much constructive adjustment of Salomon's business to new conditions.

Salomon's credit as a potential source of preferred dividends and stock redemptions improved during its 1988 recovery, when generally available dividend rates on preferred stock were roughly stable. And during 1989 Salomon was a star performer, compared to most other securities firms. With Wesco's preferred stock now shorter in contractual duration, and its conversion privilege enhanced in value during the last two years, we believe that the fair market value of Wesco's investment was somewhat in excess of its cost, and that the aggregate amount of any such excess was not material to Wesco, at December 31, 1989.

Berkshire Hathaway's Chairman, Warren Buffett, and the undersigned joined the board of Salomon on October 28, 1987, and are very pleased with the association.

Other Convertible Preferred Stocks

In transactions similar to that which created our Salomon investment, Wesco and its subsidiaries during 1989 invested a total of $75 million in several new issues of convertible preferred stock. The common stock of all issuers is listed on the New York Stock Exchange. These transactions are briefly summarized below:

(1) ***The Gillette Company***
On July 20, 1989, Wesco's Wes-FIC subsidiary invested $40 million in newly issued shares of convertible preferred stock of The Gillette Company ("Gillette"). The stock provides an 8¾% annual dividend, must be redeemed by Gillette in 10 years, and is convertible into Gillette common stock at $50 per share. Warren Buffett, Chairman of Wesco's parent company, has joined Gillette's board of directors. Gillette has just introduced a new product, the Sensor razor, which will sell well because it provides significant improvements to the wet-shaving process.

(2) ***USAir Group, Inc.***
On August 7, 1989, Wes-FIC invested $12 million in the newly issued convertible preferred stock of USAir Group, Inc. ("USAir"). The stock provides an annual 9¼% dividend, must be redeemed by USAir in 10 years, and is convertible into USAir common stock at $60 per share.

(3) ***Champion International Corporation***
On December 6, 1989, Wesco and certain of its subsidiaries invested $23 million in a new issue of convertible preferred stock of Champion International Corporation ("Champion"). The stock provides an annual 9¼% dividend, must be redeemed by Champion in 10 years, and is convertible into Champion common stock at $38 per share.

While we admire the corporations and managements involved, we regard these investments in the aggregate as sound but not exciting. Few, if any, investors have ever prospered mightily from investing in convertible preferred stocks of leading corporations. Considering alternatives available when the investments were made, we were pleased to buy the stocks, but Wesco shareholders should expect no bonanza.

New America Electrical Corporation

At the close of 1988, Wesco acquired 80% of the stock of New America Electrical Corporation ("New America Electric") for a price of $8,200,000. Of this price $7,165,000 was cash paid to a liquidating trust for the former shareholders of New America Fund and $1,035,000 was a ten-year, 10% note payable to Glen Mitchel, CEO of New America Electric, who retains the 20% of New America Electric not acquired by Wesco. The pattern of this acquisition is a common one within the Berkshire Hathaway group, where we are willing to be an 80% owner in many a business we would not be in if we did not admire and trust people who retain the other 20% and are expected to continue to operate the business, with little help and no hindrance from us.

Glen Mitchel is a long-time friend and trusted and admired business associate of the undersigned, Wesco's CEO. Indeed, because Wesco's CEO and his family owned a higher percentage of New America Electric than Wesco, our whole transaction was approved by the Wesco board with the recommendation and participation of Warren Buffett, CEO and major shareholder of Berkshire Hathaway, Wesco's parent company. Mr. Buffett had no financial interest in New America Electric, and he, plus Messrs. Munger and Mitchel, all believed that $10,250,000 was a fair valuation for 100% of New America Electric at yearend 1988.

This acquisition became available to Wesco because Glen Mitchel preferred minority (20%) ownership of a Berkshire Hathaway group subsidiary instead of dominant 30% ownership in New America Electric, with all other New America Electric stock pretty well scattered through a new public offering, which was the alternative offered. We like causing such confidence and try always to deserve it.

New America Electric is a manufacturer of various electrical products including switchgear, circuit breakers, lighting ballasts and starters and electrical equipment for marinas and mobile home and recreational vehicle parks. Its facilities are in Orange County, California.

When Wesco purchased its 80% interest, New America Electric had a book net worth of about $6,400,000, including approximately $2,500,000 in cash and equivalents, and a long history of earning high returns on capital, but with current earnings reduced by an industry-wide price war.

Unfortunately, financial results in New America Electric's first year after acquisition are an embarrassment to us. In 1989, New America Electric earned only $168,000, after taxes (before adjustments under consolidated accounting convention incident to our purchase of stock), which is (1) only 2.6% on historical book value of shareholders' equity, and (2) only 1.6% on the price Wesco paid. After consolidated accounting adjustments, the total contribution of New America Electric to Wesco's 1989 earnings was even lower: only $59,000 (included in our earnings breakdown in the "all other normal net operating income" category).

The year-to-year earnings decline at New America Electric was a stunning 77%. Part of the earnings decline was caused by high expense incurred in consolidating previously scattered operations in a large, newly leased building. Other factors were (1) escalation of the price war accompanied by a 2.5% year-to-year decline in sales, (2) a ridiculous, unfair result in a lawsuit, and (3) at least one decision which, with hindsight, looks like an error.

New America Electric's 1989 troubles were limited to the income statement. Its balance sheet remained strong. For instance, at yearend 1989, despite major improvements of facilities and purchase of new equipment, the same amount of cash and equivalents was on hand as at the start of the year: $2.5 million.

We appraise the 1989 earnings decline as temporary. We think Glen Mitchel is tackling the problems with his usual skill and diligence. We are impressed with the new building and new equipment, which will both reduce costs and improve quality of products and service. And we

admire not only Glen Mitchel but also his chief officers: Thomas Johnson, Jeff Mowry and Thomas Vogele.

We will be very supportive as operations are fixed. Our sharing of disappointing times without irrational panic is an entitlement for people who choose to make these 80%-20% deals with us. But we will not obscure, in reports to our shareholders, poor financial results, temporary or not, from any recent business acquisition. And we will be particularly anxious to highlight bad results, no matter how "immaterial" (in accountingspeak), in a case where Wesco's Chairman had an interest in the business acquired. If Wesco's shareholders don't hear much about New America Electric in the future, it will be success, not failure, which causes de-emphasis.

Consolidated Balance Sheet and Related Discussion

Wesco's consolidated balance sheet (1) retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others and (2) reflects a continuing slow pace of acquisition of additional businesses because few are found available, despite constant search, at prices deemed rational from the standpoint of Wesco shareholders.

As indicated in the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate carrying value at December 31, 1989 by about $98 million, up significantly from about $54 million one year earlier. The consolidated aggregate market value of all marketable securities, including bonds and other fixed-income securities, exceeded aggregate carrying value by about $103 million. As earlier emphasized, about $101 million of this unrealized appreciation lies within the savings and loan subsidiary, and includes $89.4 million of appreciation in stock of Freddie Mac. In addition, there is about $29 million of unrealized appreciation in common stocks (mostly stock of The Coca Cola Company) held by Wesco's insurance subsidiary. Under a peculiar accounting convention applicable only to insurance companies this appreciation, after deducting income taxes which would be due if the stocks were sold, is already included in Wesco's audited net worth, even though the gain has never passed through any audited report of income.

Wesco's Pasadena real estate comprises a full block containing (1) about 125,000 first-class net rentable square feet, including Mutual Savings' space, in a modern office building, plus (2) an additional net rentable 34,000 square feet of economically marginal space in old buildings, which it would probably be wiser to destroy than improve. This real estate has a market value substantially in excess of carrying value. The existence of unrealized appreciation is demonstrated by (1) mortgage debt ($4,643,000 at 9.25% fixed) against this real estate now exceeding its depreciated carrying value ($2,862,000) in Wesco's balance sheet at December 31, 1989, and (2) substantial current net cash flow (about $1 million per year) to Wesco after debt service on the mortgage. The modern office building is 97% rented, despite a glut of vacant office space in Pasadena. We charge just-below-standard rents and run the building as a sort of first-class club for tenants we admire. In fact, we are about to refurbish all the bathrooms, even though there is almost nothing wrong with them. (We have observed many recent instances of mismanagement at other buildings where managers prefer to paint the financial record, instead of the building. We try, with an occasional lapse, to stay a long way removed from such conduct, considering it contrary to both implicit obligation to tenants and long-run interest of the owner.) With these practices, a prime location and superior parking facilities, we anticipate future increases in cash flow, but at no better rate than the rate of inflation.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities. Following this practice, and to reduce interest costs, Wesco during 1989 paid off at

par its $25 million of 10⅛% debentures due in June 1991, and issued $30 million of new 8⅞% debentures due in November 1999. The low interest rate on the new debentures was made possible by Wesco's AA+ credit rating.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity requires patience, at least for people like us, as explained below.

It is assumed by many business school graduates, and by almost all consultants, that a corporation can easily improve its outcome by purchasing unrelated or tenuously related businesses. According to this widely shared view, if only the obvious steps had been taken, if the right "mission statement" had been adopted and the right "experts" hired, then each railroad, instead of remaining bound in chains by new forms of competition and obsolete and hostile laws and union rules, would have become another Federal Express, another United Parcel Service, or even another brilliant performer in the mode of Emerson Electric.

Our experience, both actual and vicarious, makes us less optimistic about easy solutions through business acquisition. We think undue optimism arises because successful records draw too much attention. Many people then reason as I would if I forecasted good prospects in big-time tennis after observation limited to Ivan Lendl and Steffi Graf, or good prospects in the California lottery after limiting observation to winners. The converse is also true, only more so. Far too little attention is given to the terrible effects on shareholders (or other owners) of the worst examples of corporate acquisitions such as CBS-DuMont, Xerox-Scientific Data Systems, General Electric-Utah International, Exxon-Reliance Electric, Sohio-Kennecott, First Interstate Bancorp-Allied Bancshares, Arizona Public Service-MeraBank, USX-Texas Oil & Gas, Prudential Insurance-Bache, Mobil Oil-Montgomery Ward, General Motors-Hughes Aircraft, and Avon Products-Practically Anybody. The list ends here for want of space, not a shortage of additional examples. The acquiring corporations listed are great enterprises, honorably run. In fact, their greatness augments their utility as examples as they show how hard it is, even for managers promoted to power through meritocratic procedures at admired corporations, to advance by acquisition the interests of owners.

The full implications of the worst examples are lost, in part, because the conventions of corporate reporting cause managers to present data in a manner which obscures both facts and implications. Horrible results are obscured, and mediocre results are made to look fine. Techniques for masking the truth include (1) mixing bad or mediocre results into other good results which would have been much better, absent the mixture, and (2) taking several poor results off the stage at once through the "big bath" technique. The "big bath" technique, in turn, is often accompanied by some extraordinary gain elsewhere which is cashed on a time schedule designed for obfuscation. Or a loss is mixed into a "restructuring," adopting word usage which would explain Napoleon's outcome at Waterloo as a thoughtful strengthening of France.

As we appraise it, the corporate mode of "solving your problems by acquisition" far more often ends in the mediocre "follow-the-fad-of-the-year" record of a Peter Grace than in the wonderful record of a Dover Corporation. Nor does the avoidance of dubious methodology guarantee success. It is hard to win at the game, even if one (1) does not rely on the valuation judgment of outside acquisition "experts" paid per transaction recommended and closed, and (2) does not create the in-house equivalent of the outside adviser who must buy to thrive, namely the internal department which has no function except acquisitions and often bears a label including "planning," or even "strategic planning."

Perhaps more instructive than the rarity of good corporate acquisition records is the striking rarity of important acquisitions within the few good records. Most winners act as a wise baseball hitter would if permitted to pass as many pitches as he wished before swinging.

For instance, among the best acquisition records is that of Tom Murphy and Dan Burke at Capital Cities/ABC. Yet the major acquisitions, which accounted for more than 80% of ending economic value for continuing shareholders, occurred less often than once each two years. This slow pace occurred even though they were in full control, were (and are) two of the quickest learners and actors around, did all the important work themselves, and were located in the midst of a profit- laden and long-lasting communications revolution (television broadcasting) wherein rapid change churned out opportunities for the acute at an above-normal rate. (The writer has to believe that the opportunities seized by Murphy and Burke were recognizable only by the acute. This follows from the writer's participation in rejecting a television-station opportunity, long ago given by Murphy and Burke when they were barred by law from purchase. The price was less than one-tenth of present-day value.)

A particularly depressing lesson, for the action-prone, might also be extracted from the business acquisition record of Wesco's ultimate parent, Berkshire Hathaway. Over 24 years, Berkshire transformed a small, doomed New England textile enterprise into a large and diversified company, without ending up with many more shares outstanding. Yet if you removed from Berkshire's record the six most significant acquisitions, extracting occurrences averaging one every four years, the record would not now be mentioned here, or anywhere else.

It has always been easy (indeed, one attracts scores of helpers) to make disadvantageous business purchases in a hurry with corporate cash. And it has been even easier to cause disadvantage if one is unwise enough, like General Electric in the Utah International merger, or Xerox in the merger with Scientific Data Systems, not to be super-sensitive to the probability that any attainable stock-for-stock merger will transfer more intrinsic business value than is acquired. On the other hand, advantageous business purchases, not involving competitors or branded products which can be sold through the acquirer's present sales system, are difficult to find.

It is not just the Peter Principle which makes corporate acquisition records so bad, on average, although that Principle does especially intense damage in the acquisition field. (This occurs because, when you promote the General Sales Manager to CEO making unrelated business acquisitions, you naturally cause more trouble than you earlier did when you made a less substantive change by promoting the Sales Manager of some territory to General Sales Manager.) Even a CEO with good acquisition judgment is lucky if, in his remaining career, he finds one large opportunity which tempts rational response.

The scarcity of good acquisition transactions, of course, does not imply that no wonderful businesses are ever for sale. It is just that, in a finite, competitive world, no business is so wonderful that it can't be ruined as an acquisition candidate by increasing the price. When this happens, many corporations buy anyway, for reasons Columbia's great philosopher, Charles Frankel, so well understood. The system is so constructed (irresponsibly, Frankel would say) that the corporate manager gains even though the shareholder loses. (Incidentally, Frankel was mugged to death in a final inadvertent contribution to the study of irresponsible systems, reminding many conservative social critics of Socrates.)

At this point, a last question remains: If successful corporate business acquisition is so hard, how does one explain the widespread recent success of most of the leveraged-buy-out ("LBO") operators who have purchased corporations? A huge part of the answer comes from income-tax effects and other simple effects. When, in a typical LBO, the typical mostly equity corporate capitalization was replaced by 90% debt plus a new 10%-of-capitalization common stock position:

(1) the combined market value of all the new common stock plus all the new debt became much higher than the previous market value of all the old common stock, because the existing stream of pre-tax earnings was no longer shared with corporate income tax

collectors who, in many cases, had previously received more cash each year than shareholders; and

(2) even after the value-enhancing effect of the corporate tax reduction was shared with former shareholders by paying them extra-high prices to leave, a retained residue of value-enhancing tax effect made the new common stock (which now became much like a speculative warrant with good terms) worth considerably more than cost as the ink dried on acquisition papers; and

(3) the new "owners" then resorted to strategies, difficult neither to conceive nor implement, including the following:

  (a) they eliminated many of the easily removable costs (largely personnel costs) and sub-par segments which in some mix (i) bedevil successful corporations (including ours) with sloth and folly and (ii) create their humane grace and, through present sacrifice, good long-term prospects, justifying sacrifice endured; and

  (b) they sold off a few operations at super-high prices, sometimes exercising the easiest microeconomic insight by selling to a direct competitor and sometimes selling to a surprisingly easy-to-find non-competitive corporate buyer, not owned by its managers, willing to pay almost as high a price as a competitor would; and

(4) the new "owners" then profited, in due course, not only from the tax effect and other simple reshuffling activities described above, but also from the wonderful upside effects of extreme financial leverage during a long business boom accompanied by a rising stock market.

Whether the country wants a large number (or even any) of its large corporations to have extremely leveraged capitalizations, except through occasional adversity, presents interesting social questions. Is one social function of corporations to be financially strong so that they act as shock absorbers, protecting dependent employees, suppliers and customers from part of the volatility implicit in capitalism? Was Ben Franklin right when he included the following folk wisdom in *Poor Richard's Almanac:* "It is hard for an empty sack to stand upright." Is a weak corporation, borrowed to the hilt, the social equivalent of a bridge with an inadequate reserve of structural strength? Granting that leveraged buy outs have some favorable effects (as well as unfavorable effects) on long term efficiency, how many thousands of able people do we wish to attract into promotional corporate recapitalization activity which (1) reduces corporate income taxes, (2) often tests the limits of antitrust law, and (3) focuses business attention on short-term cash generation to pay down oppressive levels of debt? Finally, as Columbia Law School's Professor Lou Lowenstein puts it (more or less): "Do we really want entire corporate businesses, as important social institutions, continuously traded like pork belly contracts?"

However the social questions are answered, three aspects of the present situation are clear. First, the corporate tax effect is so large in LBO transactions that easy success in such transactions does not imply that success is easy in ordinary corporate acquisitions. Second, the hordes of leveraged-buy-out operators now with us raise the general level of acquisition prices to the detriment of other would-be acquirers, including Wesco, which are not willing to maximize tax benefits through maximized borrowing. And, third, the LBO operators will not go away so long as present permissive laws last. The operators have a real advantage under such laws, not just a fig leaf aiding promotion. Even though failure and disgrace will reduce their number, and prices paid in leveraged-buy-out transactions will fall, the capitalized value of reducing the corporate income tax will remain. Therefore, plenty of rational incentive will remain for transactions. The LBO genie will encounter reverses, but he is not going back in the bottle unless ordered to do so by new laws.

It should also be noted that the LBO operators' incentives to bid high do not end with real advantages derived from tax law and willingness to reshuffle businesses with much speed and few scruples. Additional incentives for high bids come from typical structures in which general partners of LBO partnerships risk little of their own money (often less than none after fees are taken into account), yet share significantly in gains. Such arrangements are similar to the system of the race track tout. And who has ever seen a tout who didn't want his backer to make a lot of bets?

To Wesco, as a non-LBO operator, the good-corporate-acquisition game was always tough. And that game in each recent year has become more like fishing for muskies at Leech Lake, in Minnesota, where the writer's earliest business partner, Ed Hoskins, had the following conversation with his Indian guide:

"Are any muskies caught in this lake?"

"More muskies are caught in this lake than in any other lake in Minnesota. This lake is famous for muskies."

"How long have you been fishing here?"

"19 years."

"And how many muskies have you caught?"

"None."

When a management has our point of view, infrequency of business acquisition may safely be predicted. Whether this happens, as we like to believe, because the game is hard for almost everyone, or merely because the game is hard for us, the result for Wesco shareholders is the same: less worthwhile activity than we all would like. But there may be one consolation: A series of big, incorrectable acquisition troubles, with no meaningful salvage, is seldom caused by people who think the acquisition game is like fishing for muskies at Leech Lake. One terrible acquisition result is, of course, quite possible. For instance, Wesco would cheerfully invest $75 million tomorrow, with a 60% chance of total loss, provided the pay-off for winning was large enough to cause statistical expectation to provide a handsome return.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and insurance subsidiaries and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in very few places. Through this practice of concentration of investments, better understanding is sought with respect to the few decisions made.

The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 11% in 1987-89, was dependent to a significant extent on securities gains, irregular by nature.

The considerable, and higher than desired, liquidity of Wesco's consolidated financial position as this is written does not result from our forecast that business conditions are about to worsen, or that interest rates are about to rise, or that common stock prices are about to fall. Wesco's condition results, instead, from our simply not finding opportunities for more aggressive use of capital with which we are comfortable.

Wesco continues to try more to profit from always remembering the obvious than from grasping the esoteric. It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent. There must be some wisdom in the folk saying: "It's the strong swimmers who drown". Our approach, while it has worked fairly well on average in the past and will probably work fairly well over the long-term future, is bound to encounter periods of dullness and disadvantage as it limits action.

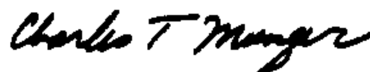
Moreover, our approach continues to be applied to no great base position. Wesco has only a tiny fraction of its total intrinsic value in businesses with enough commercial advantage in place to assure permanent high future returns on capital employed. In contrast, Berkshire Hathaway, Wesco's parent corporation, has a much larger proportion of its intrinsic value in durable high-return businesses.

The foregoing description of attitude, as well as the following historical explanation of the current situation, is repeated in the annual report each year, accompanied by a standard disclaimer designed to deter inappropriate optimism. When Wesco's parent corporation acquired control, Wesco's activities were almost entirely limited to holding (1) some surplus cash, plus (2) a multi-branch savings and loan association which had many very long-term, fixed-rate mortgages, offset by interest-bearing demand deposits. The acquisition of this intrinsically disadvantageous position was unwisely made, alternative opportunities considered, because the acquirer (including the signer of this letter) was overly influenced by a price considered to be moderately below liquidating value. Under such circumstances, acquisitions have a way of producing, on average, for acquirers who are not quick-turn operators, low to moderate long-term results. This happens because any advantage from a starting "bargain" gets swamped by effects from change-resistant mediocrity in the purchased business. Such normal effects have not been completely avoided at Wesco, despite some successful activities, including a large gain in 1985 from an investment in General Foods.

A corporation like Wesco, with no significant proportion of intrinsic value in great businesses, continues to be like a tortoise in a race of hares. And, as we have demonstrated in one more year, this particular tortoise is not very sprightly. Moreover, what sprightliness remains is often deterred by remembrance of past new-activity outcomes which were at least as bad as those of the writer's dog when it limped home from its first foray outside the yard both (1) injured by a car and (2) bloated from overeating garbage. (Some long-time Wesco shareholders may painfully remember one such once-new activity: hillside subdivision in the place with the ironic name, "Friendly Valley.")

On January 25, 1990, Wesco increased its regular quarterly dividend from 19½ cents per share to 20½ cents per share, payable March 13, 1990, to shareholders of record as of the close of business on February 28, 1990.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.



Charles T. Munger
Chairman of the Board

March 5, 1990

Reproduced on this page is a copy of the May 30, 1989 letter of resignation of Mutual Savings and Loan Association from United States League of Savings Institutions.

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315 EAST COLORADO BLVD. • PASADENA, CALIFORNIA 91101-1954

May 30, 1989

United States League of Savings Institutions,
1709 New York Avenue N. W.,
Washington, D. C. 20006

Gentlemen:

This letter is the formal resignation of Mutual Savings and Loan Association from the United States League of Savings Institutions.

Mutual Savings is a subsidiary of Wesco Financial Corporation, listed ASE, and Berkshire Hathaway Inc., listed NYSE, which are no longer willing to be associated with the League.

Mutual Savings does not lightly resign after belonging to the League for many years. But we believe that the League's current lobbying operations are so flawed, indeed disgraceful, that we are not willing to maintain membership.

Our savings and loan industry has now created the largest mess in the history of U. S. financial institutions. While the mess has many causes, which we tried to summarize fairly in our last annual report to stockholders, it was made much worse by (1) constant and successful inhibition over many years, through League lobbying, of proper regulatory response to operations of a minority of insured institutions dominated by crooks and fools, (2) mickey-mouse accounting which made many insured institutions look sounder than they really were, and (3) inadequate levels of real equity capital underlying insured institutions' promises to holders of savings accounts.

It is not unfair to liken the situation now facing Congress to cancer and to liken the League to a significant carcinogenic agent. And, like cancer, our present troubles will recur if Congress lacks the wisdom and courage to excise elements which helped cause the troubles.

Moreover, despite the obvious need for real legislative reform, involving painful readjustment, the League's recent lobbying efforts regularly resist minimal reform. For instance, the League supports (1) extension of accounting conventions allowing "goodwill" (in the financial institutions' context translate "air") to count as capital in relations with regulators and (2) minimization of the amount of real equity capital required as a condition of maintenance of full scale operations relying on federal deposit insurance.

In the face of a national disaster which League lobbying plainly helped cause, the League obdurately persists in prescribing continuation of loose accounting principles, inadequate capital and, in effect, inadequate management at many insured institutions. The League responds to the savings and loan mess as Exxon would have responded to the oil spill from the Valdez if it had insisted thereafter on liberal use of whiskey by tanker captains.

It would be much better if the League followed the wise example, in another era, of the manufacturer which made a public apology to Congress. Because the League has clearly misled its government for a long time, to the taxpayers' great detriment, a public apology is in order, not redoubled efforts to mislead further.

We know that there is a school of thought that trade associations are to be held to no high standard, that they are supposed to act as the League is acting. In this view, each industry creates a trade association not to proffer truth or reason or normal human courtesy following egregious fault, but merely to furnish self-serving nonsense and political contributions to counterbalance, in the legislative milieu, the self-serving nonsense and political contributions of other industries' trade associations. But the evidence is now before us that this type of trade association conduct, when backed as in the League's case by vocal and affluent constituents in every congressional district, has an immense capacity to do harm to the country. Therefore, the League's public duty is to behave in an entirely different way, much as major-league baseball reformed after the "Black Sox" scandal. Moreover, just as client savings institutions are now worse off because of the increased mess caused by League short-sightedness in the past, client institutions will later prove ill-served by present short-sightedness of the League.

Believing this, Mr. Warren E. Buffett and I are not only causing Mutual Savings to resign from the U.S. League of Savings Institutions; we are also, as one small measure of protest, releasing to the media, for such attention as may ensue, copies of this letter of resignation.

Truly yours,

MUTUAL SAVINGS AND LOAN ASSOCIATION

Charles T Munger

Charles T. Munger
Chairman of the Board

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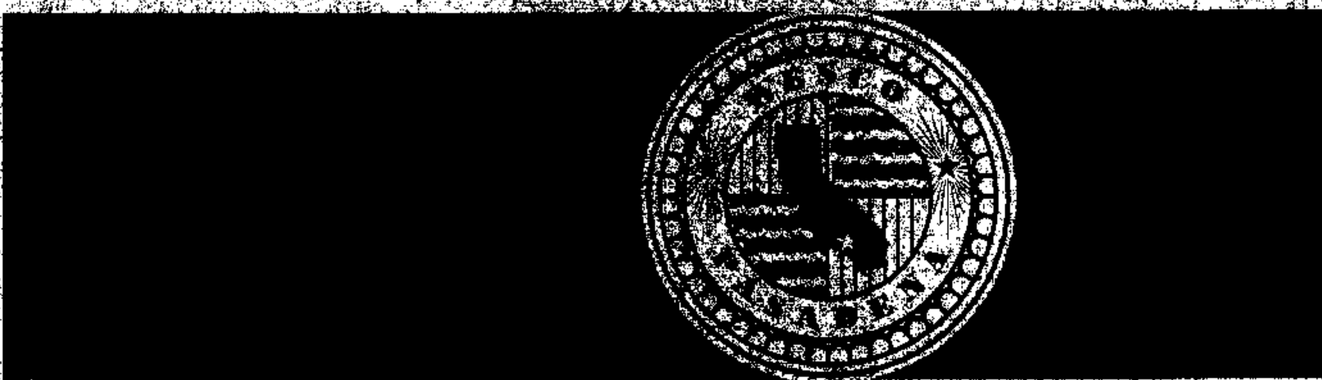


WESCO FINANCIAL CORPORATION

Annual Report 1990

Form 10-K Annual Report 1990

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" operating income (i.e., before all net gains from sales of marketable securities) for the calendar year 1990 increased to $25,038,000 ($3.52 per share) from $24,414,000 ($3.43 per share) in the previous year.

Consolidated net income (i.e., after net gains from sales of marketable securities) decreased to $25,429,000 ($3.57 per share) from $30,334,000 ($4.26 per share) in the previous year.

Wesco has three major subsidiaries, Mutual Savings, in Pasadena, Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged principally in the reinsurance business, and Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended			
	December 31, 1990		December 31, 1989	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income of:				
Mutual Savings	$ 4,099	$ .58	$ 4,191	$ .59
Wesco-Financial Insurance business	14,924	2.10	14,276	2.00
Precision Steel's businesses	1,985	.28	2,769	.39
All other "normal" net operating income[2]	4,030	.56	3,178	.45
	25,038	3.52	24,414	3.43
Net gains on sales of marketable securities	391	.05	5,920	.83
Wesco consolidated net income	$25,429	$3.57	$30,334	$4.26

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings headquarters office building, primarily leased to outside tenants, interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries, and the electrical equipment manufacturing business, 80%-owned by Wesco since yearend 1988.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

Mutual Savings

Mutual Savings' "normal" net operating income of $4,099,000 in 1990 was almost equal to the $4,191,000 figure the previous year.

As usual, these "normal-income" figures come from an abnormal savings and loan association.

Separate balance sheets of Mutual Savings at yearend 1989 and 1990 are set forth at the end of this annual report. They show (1) total savings accounts declining to $286 million from $293 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (near the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, and (4) a loan portfolio (mostly real estate mortgages) of about $131 million at the end of 1990, down moderately from $154 million at the end of 1989.

As pointed out in Note 9 to the accompanying financial statements, the book value of Wesco's equity in Mutual Savings overstates the amount realizable, after taxes, from sale or liquidation at book value. Wesco would get only about $30.8 million, after paying income taxes, from the liquidation at book value of the $47 million portion of Mutual Savings' shareholders' equity which is considered bad debt reserves for income tax purposes. The $4.1 million Mutual Savings earned in 1990 is an inadequate return (8.7%) on the $47 million amount at which we try to maintain shareholders' equity, but this same

$4.1 million is a respectable return (13.3%) on the $30.8 million which would be the after-tax proceeds of liquidation at book value.

The loan portfolio at the end of 1990, although containing almost no risk of loss from defaults, bore an average interest rate of only 9.20%, probably near the lowest among U.S. savings and loan associations and roughly the same as the 9.23% rate at the end of 1989. Because the loan portfolio is almost entirely made up of instruments of short maturity or bearing interest rates that adjust automatically with the market, there is now much less unrealized depreciation in the loan portfolio than the net unrealized appreciation in Mutual Savings' interest-bearing securities and public utility preferred stocks. That appreciation at December 31, 1990 was about $11 million.

While the "spread" between Mutual Savings' average interest rates paid on savings and received on loans remains too low to provide respectable profits, this "spread" improved again last year. The "spread" improved because interest rates paid on savings declined. Moreover, the disadvantage from inadequate "spread" has been reduced in each recent year by the effect of various forms of tax-advantaged investment, primarily preferred stock and municipal bonds. The negative side of this tax-advantaged antidote to inadequate interest rate margin on loans is the risk that preferred stock and municipal bonds, with their fixed yield and long life, will decline in value, and not provide enough income to cover Mutual Savings' interest and other costs, if the general level of interest rates should sharply rise. In view of this risk, Mutual Savings' total commitment has been kept conservative, relative to the amount of its net worth.

New federal legislation enacted in 1989, widely known under the acronym "FIRREA," is now causing Mutual Savings, step by step, to dispose of the preferred stock portion ($54.4 million, at cost, at December 31, 1990) of its tax-advantaged assets. Ownership of preferred stock has heretofore helped preserve earning power because tax-equivalent yield is so high (about 15% at December 31, 1990). Adding to our forced-disposition-of-desirable-assets problem, recent changes in income-tax law now make impracticable the replacement, as they mature, of Mutual Savings' direct holdings of municipal bonds ($16.9 million, at cost, at December 31, 1990). The municipal bonds also have a high tax-equivalent yield (about 17.5% at December 31, 1990). By mid-1994, and possibly much sooner, we expect virtually all benefit from tax-advantaged investment to vanish from Mutual Savings.

Mutual Savings remains a "qualified thrift lender" under the old federal regulatory standard (which ends June 30, 1991) requiring 60% of assets to be in various housing-related categories. It will shortly change its asset mix as necessary to comply with a new standard, imposed by FIRREA, which requires that 70% of assets be maintained in a more restricted list of housing-related assets.

Until U.S. laws governing financial institutions are further revised, Mutual Savings expects to keep its required 70% in housing-related assets within the following five categories:

(1) mortgages issued in the course of sale of individual parcels, as Mutual Savings disposes of foreclosed seaside property in Santa Barbara, California;

(2) directly made, fixed-rate house mortgages with short expected lives;

(3) indirectly made fixed-rate house mortgages with short expected lives, purchased in the open market in the form of mortgage-backed securities;

(4) a modest amount of directly made, long-term house mortgages with variable interest rates that fluctuate with the market up to 25% per annum;

(5) a substantial number of directly made, long-term, fixed-rate house mortgages given only to persons of low-to-moderate income, many in minority groups, who have good credit, reside within seven miles of Mutual Savings' office, and support Mutual Savings' loans with house equities amounting to at least 20% of house value, with the maximum size of mortgage permitted being about $191,000.

We will work hard to expand assets in category (5), covering small, long-term, fixed-rate house mortgages for local people of low-to-moderate income. Indeed this category is expected to cover a majority in number of all new directly made mortgages. We expect to impose no loan fees and to charge slightly below-market interest rates. Therefore, each new loan will cause an immediate economic loss, which will hit our earnings statement even before we sell the loans, as we plan to do. The loans will be

resold, not because they are inferior credit instruments, but because we do not wish to endure the asset-versus-liability maturity mismatch imposed by any long-term, fixed-rate mortgage.

FIRREA has increased pressure on both banks and associations to expand lending of the sort covered by category (5). As a result, in our area there can now be no lack of availability in this category of market-rate loans, meeting legislative objectives, for persons with good credit. Instead, all lenders face a shortage of qualified applicants. Given this shortage, as we now compete with bigger, better loan departments of larger institutions, the most efficient way to get our share of qualifying loans is to quote below-market interest rates and loan charges.

We do not resent making these loss-causing loans. We intend, with pleasure, to make more than our share, which we can well afford to do. We regret that we waited so long to compete vigorously for these loans and that we required regulatory prompting before we found a satisfactory solution of such simplicity. We were formerly brain-blocked, because (1) we didn't want to hold any long-term, fixed-rate loans, (2) we didn't want to impose on moderate-income borrowers the risks implicit in the only kind of variable-rate loan we were willing to make, (3) we had never routinely resold loans or deliberately loaned at a loss, and (4) we were preoccupied with avoiding calamitous results which came to many other savings and loan operators. Regulators, of course, have not demanded that we now lend at a loss. That aspect of our program is the result of our initiative alone.

We have had trouble attracting a significant volume of loans, with satisfactory characteristics, in category (4), covering our variable-rate loans which can escalate to bear interest rates of 25%. These loans have been in short supply despite our use of a very low interest rate spread (about 2 percentage points over the one-year U.S. Treasury rate). Moreover, while we have realized no losses on our variable-rate loans, we have encountered several collection delays, partly attributable to an incompetent policy decision of the Chairman. These two factors cause us to expect this category to shrink to minor significance.

Category (3), the short-term, fixed-rate, mortgage-backed security category, is a "last-resort" category for us. But it could eventually amount to a substantial percentage of assets, depending on what is available elsewhere.

As we select mortgage-backed securities, we will probably not be buying any complex instruments. Despite our love of comedy, we are going to avoid the newest form of "Jump Z tranches in REMICS." This refers to a particular contractual fraction — the "Z Form" — of a pool of mortgages, now subdivided by obliging issuers, advised by obliging investment bankers, into two new contractual fractions: (1) the "Sticky Jump Z" and (2) the "Non-Sticky Jump Z." At this rate, subdivision will soon get down to quarks.

We are deterred from buying such securities partly by our hatred of complexity. We also dread the prospect of state and federal examiners, none of whom has a Ph.D. in physics, reviewing, one after the other, our choices for soundness and billing us on a cost-plus basis to reflect value thus added. Some of the wonders of modern finance go on without us as we yearn for a lost age when most reasonable people could, with effort, understand what was going on.

In total, during the next few years, our policies will very likely cause our housing-related assets (exclusive of the one-time effect of development of our foreclosed seaside property) to continue to produce close to the lowest average gross return in the savings and loan industry. Incremental returns may not quite cover incremental interest and operating costs as we invest each new dollar of savings. It is quite conceivable that Mutual Savings will decline in size because it should decline in size.

Even so, we expect that Mutual Savings will muddle through in a manner satisfactory to Wesco shareholders with moderate expectations. Our optimism comes mainly (1) from an expected minor profit boost from disposition of our foreclosed seaside property and (2) from an expected major profit boost caused by ownership of our large holding of Freddie Mac stock. Both of these grounds for optimism are discussed below.

Mutual Savings has a buried value in a piece of foreclosed property: 22 seaside acres in Santa Barbara, acquired in 1966. By the time Mutual Savings started development (into 20 houses and 12 lots) in order to facilitate sale, the value of this property had appreciated by at least $12 million. The built-in appreciation will now be captured through development, assuming no large reverses caused by collapse of housing prices or unanticipated new regulatory troubles.

The first house is nearly finished, and about 15 houses are under construction. We expect to close sale of about half the parcels during the next year. There will be little or no profit added to built-in appreciation by the development process. Seaside land development, under present regulatory and market conditions in California, tends to be a no-profit activity — if you are lucky. It is full of queer happenings and closely resembles a Chevy Chase movie of extreme duration.

In 1988 Mutual Savings made a large and unusual purchase. It increased its holdings of Federal Home Loan Mortgage Corporation (widely known as "Freddie Mac") to 2,400,000 shares, 4% of total shares outstanding. Mutual Savings' average cost is $29.89 per share, compared to a price of $48.75 per share in trading on the New York Stock Exchange at the end of 1990. Thus, based on 1990 yearend trading prices, Mutual Savings had an unrealized pre-tax profit in Freddie Mac shares of about $45.3 million. At current tax rates the potential after-tax profit is about $26.7 million, or $3.75 per Wesco share outstanding.

Freddie Mac, created and long run by a federal agency (the Federal Home Loan Bank Board), is now owned privately, largely by institutional investors. It is now led by a very smart CEO, Leland Brendsel, and governed by an outstanding independent board of directors, including John B. McCoy of Banc One and Henry Kaufman, former chief economist of Salomon Brothers. Freddie Mac supports housing primarily by purchasing housing mortgage loans for immediate transmutation into mortgage-backed securities that it guarantees and promptly sells. In the process Freddie Mac earns fees and "spreads" while avoiding most interest-rate-change risk. This is a much better business than that carried on by most (or indeed most of the top 10% of) savings and loan associations, as demonstrated by Freddie Mac's high percentage returns earned on equity capital in recent years. One ironic cause of the high returns is that this creation of federal regulators pays no deposit-insurance premiums as it replaces much of the former function of the savings and loan industry. Freddie Mac's high returns on equity are caused by a strong competitive position that is likely to last a long time. In its activities it faces only one other competitor of similar size, efficiency and reputation: Federal National Mortgage Association (widely known as "Fannie Mae"), a similar private corporation with governmental overtones.

At Freddie Mac's 1990 dividend rate ($1.60 per annum per share), Mutual Savings' pre-tax yield was only 5.35% on its $29.89 average cost per share. Post-tax, the dividend yield was only 4.4%, but this amounted to about 75% of the current after-tax yield from very high grade mortgages. Moreover, Freddie Mac has a creditable history of avoiding really hurtful loan losses and increasing its earnings and dividend rate, virtues that contribute to increases in the market price of its stock. Following are figures for 1985-1990:

Year Ended 12/31:	Earnings per Share	Dividends per Share	Year-End Market Price per Share	Freddie Mac's Return Earned on All Average Equity
1985	$2.98	$ .53	$ 9.19	30.0%
1986	3.72	1.13	15.17	28.5
1987	4.53	1.10	12.12	28.2
1988	5.73	1.25	50.50	27.5
1989	7.28(1)	1.60	67.12	25.0
1990	6.90	1.60(2)	48.75	20.4

(1) restated

(2) raised to annualized rate of $2.00 per share on March 8, 1991

Despite Freddie Mac's strong competitive position, its stock declined in market value by 27% in 1990 (from $67.12 per share to $48.75 per share, in trading on the New York Stock Exchange). One reason for the decline was unanticipated losses from apartment house loans, particularly in New York and Atlanta. As a result, Freddie Mac wisely discontinued the most obviously dangerous part of its apartment house loan buying program. But it remains the guarantor or owner of some old loans (fortunately a small portion of total apartment house loans and a really tiny portion of total loans) that will create misery for years. It was probably ill-advised for Freddie Mac, given its position and financial leverage and the nation's needs, (1) ever to finance anything except owner-occupied, single-family, non-vacation houses, for which substantial down payments had been made by credit-worthy people, and (2) ever to deal with anyone other than mortgage originators and servicers of obvious integrity and

competence. Just as it is unwise for an individual to risk losing what he has and needs in an effort to gain what he doesn't have and doesn't need, it seems unwise for Freddie Mac to stretch its leveraged resources beyond purchase from obviously responsible people of carefully selected first mortgages on individual houses. Each lender, including the one writing this letter, seems destined to learn through painful, personal experience two obvious lessons from the past:

(1) The first chance you have to avoid a loss from a foolish loan is by refusing to make it; there is no second chance.

(2) As you occupy some high-profit niche in a competitive order, you must know how much of your present prosperity is caused by talents and momentum assuring success in new activities, and how much merely reflects the good fortune of being in your present niche.

In common experience, including ours, lesson (1) is eventually learned, but lesson (2) resists learning, despite high pain inflicted by multiple reverses.

As nearly as we can foretell, Freddie Mac's troubles with apartment house loans are endurable in scale and will no more significantly impair its long-term prospects than the salad oil swindle of 1963 impaired the long-term prospects of American Express. Moreover, the present managers and directors of Freddie Mac all seem to have absorbed a catechism appropriate for Freddie Mac and to be willing to endure political friction burns as necessary to keep operations sound. We like our large position.

Strangely, Mutual Savings' holdings of Freddie Mac, while lawful to own under FIRREA, (1) so far do not count as "housing-related assets" in the new 70%-of-assets test, and (2) must be written down, in stages, to a value of zero for regulatory accounting purposes. As these provisions start to bind, Mutual Savings will dispose of part of its Freddie Mac stock. One option is the transfer of stock to another Wesco subsidiary in return for cash.

What future in the savings and loan business do we expect? We don't know anything more than that we are satisfied at the moment with our temporizing strategy. We expect further changes, possibly radical, in the bank/savings-and-loan-association field, to which we will adapt as they unfold.

The present situation, with its many insolvent and almost-insolvent institutions, is such a mess that further legislation seems inevitable. We can predict neither the changes, nor whether the changes will make matters better or worse. But we do have some opinions. These opinions are almost totally out of step with current thinking in academia, among government officials, among banking executives and, most of all, among banking lobbyists. Despite this unconventionality, our opinions are now given to Wesco shareholders because they may provide some insight into our institutional nature and likely future action. We also hope, but only slightly, that the opinions, set forth below, will have a wider, civic utility.

First, let us turn to banking, after which we will consider the savings and loan business.

The sum of all deposit-insurance losses in banking will probably be much lower than the $200 billion or so recently caused by savings and loan associations. But there are a lot of very sick banks, and deposit-insurance losses are sure to be large. Moreover, even if there had been no such losses, there would be much to regret in the nature of our modern banks as they have increasingly emphasized lending for consumption (even lending at 20% for vacations in Tahiti) and lending to financial promoters and real estate developers. We have come a long way from an ideal emphasizing the banker's provision, to both big and small businesses, of what Pierre DuPont provided to General Motors. Plainly, we have a two-forked banking problem, with a questionable shift in priorities accompanying rising insolvencies.

Let us attempt to diagnose the causes of our problem. By and large, our problem did not come because banks couldn't branch across state lines, sell insurance, or underwrite corporate securities. Instead, it came because banks "reached" for higher yields on assets as they faced higher interest costs that came from (1) decontrol of interest rates paid by insured institutions plus (2) pressure from new competitors, including money-market funds possessing a large competitive edge.

Exactly how great is the money-market funds' competitive edge? To see, compare the average heavily regulated bank, paying high deposit-insurance premiums, with what has been created in an

extreme form of uninsured money-market fund. In the fiscal year ended June 30, 1990 one such $4 billion fund (The Common Fund for Short Term Investments) did all of the following:

(1) kept its assets in liquid short-term obligations of the U.S. government and other credit-worthy entities;

(2) furnished efficient checkwriting privileges and wire transfer service to its depositors;

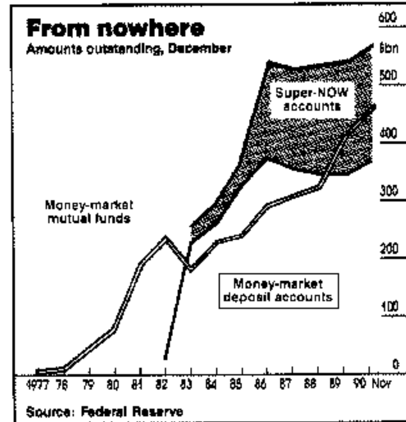
(3) kept its *total* operating costs under two-tenths of 1% of deposits per annum as it avoided costs of maintaining branch offices, deposit insurance, etc.;

(4) furnished no capital of its own as a cushion supporting promises to depositors; and

(5) paid very competitive rates on its interest-bearing accounts, as a result of which it grew 27% in size.

This example demonstrates the raw competitive power of keeping things simple. Indeed, in this example all costs combined have been controlled so as to be roughly equal to what the average local bank pays for federal deposit insurance alone! We are not dealing with some minor competitive advantage. The new competition is a juggernaut.

How important has the new competitor become? Naturally, the new competitor has taken a huge bite out of the market formerly served by banks (and savings and loan associations) burdened by much higher costs. How could it be otherwise? Here is a dramatic graph reprinted from what is surely among the best magazines in the world, England's *The Economist*:



The money-market funds are, in substance, "non-bank" banks, furnishing interest-bearing savings and checking accounts. And, by an odd stroke of good fortune, their light regulation by an overburdened SEC has turned out to be more advantageous than no regulation at all. The rules of the SEC force investment largely confined to reasonably safe and liquid categories. This has spawned simple operations with very low costs.

The simple, low-cost*, cream-the-market approach thus taken (or stumbled into) often works well in business. For instance, look at (1) GEICO, a hugely successful auto insurer almost 50% owned by Wesco's parent corporation or (2) various membership warehouse clubs, in the form invented by Sol Price, which are now clobbering retailing competitors as they get total "markup" under 10%. And this approach, as would be expected, is working like gangbusters for the money-market funds, as you see in the graph from *The Economist.*

What were the effects on banks as these new and successful, low-cost competitors took more and more of the market while, at the same time, each bank's banking competitors could bid as they wished

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* Total costs are low, even though they include fees containing a substantial profit element that are paid by the "non-bank" banks to the "non-independent" independent managing companies employed in conformity with mutual fund practice. While Lewis Carroll might have liked the consistency of the nomenclature just used, it is not clear that it befits a banking system. "Pretending" under misleading labels is not a good idea in banks. All "pretending" habits tend to spread.

for funds, using the government's credit? Well, naturally, almost every bank, being inherently saddled with much higher costs, and not wanting to go out of business, tried to get higher contractual interest rates on its loans. And this caused greater emphasis on loans for consumption and loans to financial promoters and real estate developers. Indeed, many of our most decisive bankers, quite logically, stopped trying to make loans to their most credit-worthy customers, accepting the disappearance of any important linkage between our best banks and our best businesses. The banks had been forced into an entirely different market niche (which already had some occupants): high-interest-rate lending.

And what can be expected when virtually all banks become specialists in high-interest-rate lending? It is hard to know for sure, because, throughout the past, high-interest-rate lending was hard to fund since it came from skeptical sources, instead of from government-insured deposits. Really large-scale, high-interest-rate lending is a comparatively recent phenomenon, made possible by governmental support in the form of deposit insurance used by banks with altered natures. But such experience as exists gives a likely answer: many bank insolvencies will come. Just as the simple, low-cost, cream-the-market strategy is a common business winner, the opposite strategy, involving high costs and high prices, is a common loser. High interest rate lending as a field has usually provided (1) some winners and (2) many casualties, often coming in bunches after periods of "follow-the-leader" asset-quality debasement. (Remember the widespread disasters in R.E.I.T. lending.) And the past bad experience should naturally worsen as the high-interest-rate lending field both expands and becomes overcrowded, driven by governmental support.

We are not alone in our diagnosis. Here is an excerpt from a recent *Wall Street Journal* editorial: "When more efficient, uninsured and less regulated financial institutions creamed off profitable lines of business, the [Bank of New England] was left concentrated in commercial real estate. This artificially diverted money into Boston's building boom, which inevitably became a bust."

Granting the presence of perverse incentives, what are the operating mechanics that cause widespread bad loans (where the higher interest rates do not adequately cover increased risk of loss) under our present system? After all, the bad lending, while it has a surface plausibility to bankers under cost pressure, is, by definition, not rational, at least for the lending banks and the wider civilization. How then does bad lending occur so often?

It occurs (partly) because there are predictable irrationalities among people as social animals. It is now pretty clear (in experimental social psychology) that people on the horns of a dilemma, which is where our system has placed our bankers, are extra likely to react unwisely to the example of other peoples' conduct, now widely called "social proof." So, once some banker has apparently (but not really) solved his cost-pressure problem by unwise lending, a considerable amount of imitative "crowd folly," relying on the "social proof," is the natural consequence. Additional massive irrational lending is caused by "reinforcement" of foolish behavior, caused by unwise accounting convention in a manner discussed later in this letter. It is hard to be wise when the messages which drive you are wrong messages provided by a mal-designed system.

In chemistry, if you mix items that explode in combination, you always get in trouble until you learn not to allow the mixture. So also, in the American banking system. To us, a lot of foolish, unproductive lending and many bank insolvencies are the natural consequences, given existing American banking culture, of the combination of the following two elements alone:

(1) virtually unlimited deposit insurance; and

(2) uncontrolled interest rates on insured deposits.

These two elements combine to create a Gresham's law effect, in which "bad lending tends to drive out good." Then, if factor (3) below is added to an already unsound combination, we think deposit-insurance troubles are sure to be further expanded — and not by a small amount:

(3) relatively unregulated, non-insured, low-cost "non-bank" banks.

Moreover, when the government starts suffering big deposit-insurance losses, if it continuously responds (in a natural, unthinking reaction) by raising deposit-insurance prices, we think it creates a "runaway-feedback" mode and makes its problems worse. This happens because the government, by adding even more cost pressure on banks, increases the cause of the troubles it is trying to cure. The price-raising "cure" is the equivalent of trying to extinguish a fire with kerosene.

Many eminent "experts" would not agree with our notions about systemic irresponsibility from combining (1) "free-market" pricing of interest rates with (2) government guarantees of payment. If many eminent "experts" are wrong, how could this happen? Our explanation is that the "experts" are over-charmed with an admirable, powerful, predictive model, coming down from Adam Smith. Those discretionary interest rates on deposits have a "free-market" image, making it easy to conclude, automatically, that the discretionary rates, like other free-market processes, must be good. Indeed, they are appraised as remaining good even when combined with governmental deposit insurance, a radical non-free-market element.

Such illogical thinking displays the standard folly bedeviling the "expert" role in any soft science: one tends to use only models from one's own segment of a discipline, ignoring or underweighing others. Furthermore, the more powerful and useful is any model, the more error it tends to produce through overconfident misuse.

This brings to mind Ben Graham's paradoxical observation that good ideas cause more investment mischief than bad ideas. He had it right. It is so easy for us all to push a really good idea to wretched excess, as in the case of the Florida land bubble or the "nifty fifty" corporate stocks. Then mix in a little "social proof" (from other experts), and brains (including ours) often turn to mush. It would be nice if great old models never tricked us, but, alas, "some dreams are not to be." Even Einstein got tricked in his later years.

We may be right or wrong. But, if we are right, if there are deep, structural faults in the American banking system, it follows that merely giving banks the right to branch across state lines, to sell insurance, or to enter investment banking (or all of the above) is not going to end our troubles.

Instead, a good long-term fix can come only after the government considers more extreme modifications in the system, each of which has powerful, vocal opponents. What are the more extreme modifications to consider? We think the list includes:

(1) greatly reducing deposit insurance;
(2) eliminating money-market funds;
(3) bringing back some form of controls on interest paid on insured deposits;
(4) intensifying regulatory control of bank lending in an attempt to reduce loan losses;
(5) forcing more conservative accounting covering bank lending;
(6) forcing weak banks into other hands before the weak banks become insolvent; and
(7) forcing insolvent banks into competing local banks, or entirely out of business, instead of into strong, out-of-state banks.

Let us next attempt a brief discussion of the merits and/or political prospects of each of these seven governmental options.

Option (1): greatly reducing deposit insurance:

To many people, remembering former banking panics, this option, adopted fully, seems like trying to solve the overcrowding problem by bringing back cholera. Accordingly, proponents of this option typically would limit its effects by (1) bringing back bank "runs" only for small banks (big banks, regardless of law, are "too big to fail" in all advanced countries) and (2) bringing back deposit losses only to some rich depositors. Because voters don't like bank "runs" of any size, and small banks don't like discrimination, it seems unlikely that reductions in deposit insurance are going to be made on a scale that solves the structural defect problem. Conceivably, "brokered" deposits could be removed from insurance coverage, in a move driven by legislative remembrance of many abuses involving stockbroker-assisted financing of despicable insured institutions. (Many stockbrokers could easily see that the insured certificates of deposit they were paid to sell were issued by institutions managed by knaves and fools, presiding over piles of junk loans and junk securities. The stockbrokers thus knew, or should have known, that their government was being robbed. To sell certificates under such conditions was a lot like finding currency in a post office bag and deciding it was ethical to keep it.)

Option (2): eliminating the money-market funds:

This option is almost never discussed. This seems peculiar. The money-market funds came into being without public policy input when some clever person combined (1) mutual fund status under the S.E.C. with (2) purchase, under subcontract, of services from a bank. What was created was, in essence, a virtually unregulated, uninsured bank furnishing interest-bearing savings and checking accounts. The creation of such entities would probably not have been authorized if new legislation had been necessary. Where else do we have virtually identical regulated and unregulated entities operating on the same scale, side by side? If new legislation had been needed, the following questions might have been raised:

(1) What do money-market funds do for "community" lending, lifeline services to the elderly, etc.?

(2) Are they fair to existing institutions?

(3) Won't the new "non-bank" banks make it harder for the Federal Reserve System to render constructive economic service?

(4) Since the public is already on the hook as guarantor of solvency of existing institutions, is it wise for the guarantor to risk losses from allowing uninsured, cream-the-market, more efficient operators to add to the competition? (This question would not be hard to answer in a private setting. If you were guarantor of all obligations of your brother-in-law's hamburger joint, you would consider it very foolish to allow McDonald's to commence operations by his side when you possessed the ability to prevent it.)

(5) Considering all of the above (and more), are the money-market funds in the long-term interest of the soundness and service of the total banking system?

These questions are still good questions. But possession is strength under law. The money-market genie is now out of the bottle. And, considering his size, it would be hard to put him back. The prospects of rebottling are plainly remote.

Option (3): bringing back some form of controls on interest paid on insured deposits:

This option, too, is now seldom discussed. Again, this seems peculiar. It is among the first things you or I would consider if we had to guarantee all obligations of that hamburger joint owned by a brother-in-law. We would no more guarantee an 11% obligation for him, when we could easily borrow at 8%, than we would burn currency in the fireplace. In fact, we would suspect dishonorable "monkey business" if an 11% transaction occurred.

One reason for present lack of legislative interest in interest-rate controls lies in the knowledge that a former version of such controls constricted housing credit when interest rates rose to high levels. No one now seems interested in trying to develop new controls, more flexible in form and practice, that would avoid former defects. Nor is anyone much interested in the success the Japanese (or the United States) had during a long period of control of interest rates paid by banks. The interest-rate-control option, at the moment, seems dead.

Option (4): intensifying regulatory control of bank lending in an attempt to reduce loan losses:

This option is already being exercised — erratically — with effects both good and bad. It certainly has successful counterparts in non-banking businesses. For instance, take McDonald's franchised restaurants. If you want to use the McDonald's authenticating name and arches on your restaurant, you have to operate in a very limited, foolproof way. Moreover, the McDonald's approach once worked in banking. When deposit insurance first came in, and long thereafter, most insured banks operated in simple, sound fashion, often through ill-paid employees. But, based on all recent precedents, the government won't now act like McDonald's, or itself in a former era. (If it wished to do that, it might now give deposit insurance to all the simple, sound money-market funds, lending to big business through purchases of commercial paper, and take deposit insurance away from all the banks and savings and loan associations!) Government, instead, will probably take the more limited approach of concurrently: (1) leaving banking over-stressed by competition, (2) leaving banking very complicated, (3) trying to prevent problems by writing massive, hard-to-understand regulations that create more work for lawyers, and then (4) monitoring bank operations through overburdened civil servants. These limited remedies may be better than nothing, but their prospects for causing a real banking fix seem poor. It is almost a

general rule of American life that, when incentives are all wrong, controls (even criminal-law controls) can't fix our troubles. We can expect limited good effects from Option 4 and the continuation of important, basic problems.

Option (5): forcing more conservative accounting covering bank lending:

Bank accounting is a hot current topic, but conservatism is not the goal. Everyone is wondering how much to delay loan write-offs, when loans go sour, so as not to over-correct weak banks. We are not going to enter the lists on that problem.

The almost-never-discussed problem that interests us is that presented by newly made loans, bearing high interest rates, that under current bank accounting tend to be treated as "born good." The result is that all interest accrued, and sometimes some up-front fees, are treated as fully earned, even though the final outcome of the whole loan transaction is far from clear. To us, this is counterproductive accounting, even though we use it ourselves when pushed by convention.

We think current accounting for many high-interest-rate loans has terrible consequences in the banking system. In essence, it "front ends" into reported income revenues that would have been deferred until much later, after risky bets were more clearly won, if more conservative accounting had been employed. This practice turns many a banker into a human version of one of B. F. Skinner's pigeons, since he is "reinforced" into continuing and expanding bad lending through the pleasure of seeing good figures in the short term. The good figures substitute nicely in the mind for nonexistent underlying institutional good, partly through the process, originally demonstrated by Pavlov, wherein we respond to a mere association because it has usually portended a reality that would make the response correct.

Under prevailing accounting, banks now ordinarily report increases in both earnings and equity capital during any transition they make toward less conservative lending. And then, if more lending of that type is done, and is accompanied by growth in institutional size, good reported figures will continue for an additional period. If an increase in institutional size is deemed necessary, it is, of course, assured by the bank's access to the government's credit through deposit insurance.

We think acculturated corporate nature, in American financial institutions, simply cannot, on average, handle temptations implicit in this sort of accounting. Indeed, the succumbing to the temptations, in a manner not consistent with long-term institutional interest, often occurs through a subconscious process. The subconscious process includes bad effects from both (1) "social proof," and (2) a "reality-denial" mode that creates bias in people stimulated, honored and paid in proportion to institutional size. Under our present system a Columbia Savings, and many less obscene versions of its model, are almost inevitable.

Of course, a large minority, even a majority, of bankers will remain sound, despite the temptations. But this outcome is not sufficient to protect the deposit insurer from unacceptable ultimate losses. In due course, given present conditions, the deposit insurer will suffer from what some wag called the problem of there being so many more banks than bankers.

What should now be considered are mandatory accounting changes, including changes in accounting to shareholders, designed to force "back-ending" into reported income of revenue from various types of gamy lending (and letters of credit), in lieu of allowing "front-ending" to continue. The changes would cause American bank accounting, by fiat, to imitate what some of the best European bankers have long done by choice. Eventually, credibility might be returned to banks' audited financial statements, now often regarded as fairy tales.

Despite the obvious (to us) accounting defects that bedevil our system, we don't think any wise and important accounting changes will be made. Typical bank reaction to such proposals is, at best, that of the man who asked, well before his ultimate sainthood: "God, give me chastity, but not yet." Also, time periods for accomplishing even the simplest, "no-brainer" changes in accounting convention tend to stretch into years.

Option (6): forcing weak banks into other hands before the weak banks become insolvent:

This option is also a hot topic. Usual governmental practice at the moment is to force merger only when all shareholders' equity is gone and the deposit insurer has a large loss. This is "bonkers," due process gone mad. It seems entirely logical now to commence the forced merger or closure of many of the nation's 13,000 banks and to do it in many cases before a weak bank is insolvent. Because the need

is so obvious, laws and customs may possibly change to cause more of this to happen. And interstate branching may be allowed in order to enlarge the number of potential bank buyers.

While these steps seem helpful, they won't fix the problem of deep structural fault in the system — at least within any acceptable time period. Look at the present carnage in airlines. Even when we are down to fewer than a dozen significant operators, messy airline failures continue. If we wait for an airline-style solution in banking, we will have to endure years, maybe decades, of suffering.

Option (7): forcing insolvent banks into competing local banks, or entirely out of business, instead of into strong out-of-state banks:

According to Martin Mayer, writing recently in *The Wall Street Journal*, the FDIC now typically deals with an insolvent bank by choosing between two options:

(1) forcing the insolvent bank into a competing local bank, or entirely out of business, thus dampening local competition; or

(2) first, replacing all the insolvent bank's bad assets with good assets, and, second, selling it to some skillful out-of-state buyer, after which process the new bank can help clobber the remaining also-weak-and-also-insured banks in the area.

Mayer believes it was "insane" for the FDIC to do as it did in many instances, which was to select option (2). According to Mayer, the FDIC thus arranged that "overcapacity was rigorously maintained." Mayer raises an interesting question. Coming back to the analogy earlier used, if you or I were really unlucky and were guarantor for seven local brothers-in-law, each with a troubled hamburger joint, what would we do when the first one went broke? We would surely reject the idea of, first, fixing up the defunct joint so that it was better than the others, and, second, guaranteeing the obligations of a new and more skillful out-of-state operator who wanted to enter the market by taking over the improved facility.

Mayer is right insofar as he implies that there are too many banks and bank branches, just as there were formerly too many filling stations, sometimes three or four at an intersection. The departed filling stations "never will be missed," so perhaps the FDIC should "have a little list," like the bloodthirsty figure in the Mikado.

Beyond that, we are not certain that Mayer's conclusions will always prove right. The basic banking system is right out of *Alice in Wonderland*, so maybe it's like non-Euclidean geometry and only *Alice-in-Wonderland*-type cures really fit in. After all, the scenario which troubles Mayer has a perverse beauty, at least to a government. The bank failures cascade, on and on, refreshed by new governmental acts, so that the FDIC can be saving a large part of the banking system each year for a long time.

And we must admit that, if we were the FDIC and were thus forced to participate heavily in our present banking system, like it or not, we would occasionally do what Mayer finds objectionable, in those rare cases when we saw a chance for greatly improving banking culture in some community. We would, for instance, occasionally sell a sick bank to John McCoy (of Banc One), even when this brought a new bank to a state full of troubled banks, if every in-state bank seemed too weak or foolish to be selected as an alternative buyer. We would figure that (1) some subsequent insolvencies of other local banks were in our long-term interest, (2) we were supporting a sound model, and (3) eventually, as the example spread, our troubles as deposit-insurer of a silly system would be reduced. We would then have a pleasant lull before the silly system caused new troubles to pop up, maybe even under McCoy's successors at Banc One.

While Mayer's subject is interesting, we probably don't have to worry much about worldly consequences. Outside science, it is amazing how little impact there can be from a powerful idea, published in a prominent place (such as the *Journal*). Everyone's experience is that you teach only what a reader almost knows, and that seldom.

If our foregoing comments about systemic irresponsibility and chances for a rational cure are right, or substantially right, it is hard to be optimistic about coming legislative "reform" of banking. Perhaps the best we can hope for is Menckenian reform where old error is replaced, not by truth, but by new error. It is also possible that we will see exactly the same old systemic error repeated, but bearing bells

and whistles in the form of new bank powers. This outcome is roughly what is recommended by the banking lobby, which has evidently learned nothing from the history of the savings and loan laws.

Let us next turn to the savings and loan field. Here, faced with a more disastrous mess, the legislators were so outraged that they attempted what they thought was extreme reform: FIRREA. This legislation took a "back-to-basics" approach and has since been interpreted by regulators who seem to believe, understandably, that they must act as though they were tough "bouncers," given the job of bringing order to a drunken brawl (a description that understates what the regulators faced).

This regulatory approach is now squeezing out (1) much folly, and (2) some non-folly needed to keep institutions healthy. Most executives we know at other associations concentrate only on the negative side and are outraged at instances of regulatory elimination of non-folly. They tend to construe present FIRREA enforcement as the equivalent of Mark Twain's prescription for preventing children's stuttering: "Remove the lower jaw."

Our view is different, even though we are much harmed by FIRREA. We think the system needed new rules, interpreted by tough "bouncers," and that the "bouncing" process, done with sufficient vigor, inevitably involves some lumps for the undeserving. There may even be some deaths from "friendly fire." Nonetheless, the process must go on.

What concerns us is the most important question of all. Did our legislators, through FIRREA, even with their "never again" mindset, fix the most important systemic error in the savings and loan industry? We think not.

As the dust has cleared, the best savings and loan associations are clearly worse businesses than the best banks (which themselves have plenty of troubles). This conclusion is supported by both (1) stock market prices and (2) action of governmental liquidators in response to market conditions. Stocks of the best associations now sell at much lower price/book-value ratios than stocks of the best banks. And governmental liquidators are constantly selling association branches to banks while almost never selling bank branches to associations. FIRREA has not made associations, on average, as desirable for owners as banks. The two institutional types remain different and unequal, while quite comparable in essential residual function, now that Fannie Mae and Freddie Mac exist to perform a lion's share of the finance function supporting housing.

The savings and loan system, in a modern era in which the government is always a large net borrower, still tries to use short-term savings accounts to finance long-term housing lending. This is, in essence, a very bad idea, violating the logic of an elementary prescription: "If a thing isn't worth doing at all, it isn't worth doing well."

To be sure, some fix of systemic maturity-mismatch risk is now attempted, through encouragement of variable-rate loans. But the variable-rate loans typically "cap" interest rate escalation at a few percentage points, which must be done for moderate-income borrowers to prevent both (1) unacceptable hardship and (2) sudden falls in non-housing spending. This compromise is like having building codes in California protect only up to 5 points on the Richter earthquake scale. The compromise is almost sure to bring back, probably at a remote date, another horrible collapse of the savings and loan system.

As we say this, we are not critical of the best California associations, such as Home Savings, Great Western Savings and World Savings. These people have logical operations bearing one big systemic risk that cannot be avoided by permanent players. If we had to play forever under current rules, we would try to imitate them. But we would have a big disadvantage: "we don't know how to get there from here," because they have such momentum in systems, particularly in loan origination. Fortunately, no one is sentencing us to play forever in a game with a systemic risk we don't like and in which we are at a big disadvantage. Instead, we have temporized with a different, acceptable "there" in a form combining (1) a big holding of Freddie Mac, with (2) financial flexibility to adapt as we choose to new conditions.

So much for ridicule, pessimistic speculations, and excuses for our defects, always easy to provide. As any responsible calamity-howler should, we will now risk playing the fool in public by attempting to say what we would do with the bank/money-market fund/savings and loan system if we were Congress:

(1) Because we have a help-housing bias, we would keep government-assisted housing finance for low-to-moderate-income people. We would do this by forcing pension funds to maintain a significant portion of their assets in housing-related assets in the form of Freddie Mac and Fannie Mae mortgage-backed securities representing interests in fixed-rate mortgages. This

requirement strikes us as fair, given the tax exemption possessed by the pension funds. And the pension funds are the logical suppliers of housing finance because they by nature have (a) massive assets, and (b) liabilities with maturities matching homeowners' needs for long-term, fixed-rate credit. Our reason for specifying Freddie Mac and Fannie Mae securities as a conduit for housing assistance is our belief that these entities would assure loan quality better and more cheaply than would any government bureaucracy. In quantitative terms, we would leave housing finance more assisted than it is now, particularly for first-time home buyers who have won their spurs.

(2) We would merge the banks, money-market funds and savings and loan associations into one banking system, with insured deposits. The new banking system would be separate from both (a) industry and (b) the part of investment banking likely to disappoint investors. It would have the following characteristics:

(i) There would be one federal regulator that also served as deposit-insurer, in lieu of the truly crazy, inefficient Balkanization of our present regulatory and insurance apparatus. (Eliminating Balkanization would do more than reduce costs, delays, confusion and competition in laxity. There is a system-design advantage in making the deposit-insurance loss payer and the bank-controlling loss preventer one and the same. The system then becomes more "responsible" in the Frankelian sense, requiring that systems be organized, to the extent feasible, so that decision-makers, not others, bear consequences of decisions.)

(ii) There would be no bank-holding companies, but the new banks would have a monopoly in offering check-writing privileges, debit cards and credit cards, except for credit cards offered on behalf of a single vendor. (The new law would permit tax-free spinoffs of existing banks, newly organized banks, and non-banks to help existing corporations come into compliance. Spun-off non-banks could include specialists in high-interest-rate lending to businesses.)

(iii) Flexible, government-regulator-run controls would set a ceiling on interest that could be paid on bank accounts. (If you are going to guarantee the credit of an entire industry, there is a limit to the competition that is desirable. Besides, many banks will behave badly in their important function when they are under the extreme cost pressure, not normal in business, that occurs when one's competitors are all financed without limit by the government, through deposit insurance.)

(iv) All capital satisfying regulatory requirements would have to be in the form of stock, either common or preferred, except for "grandfathered" debt.

(v) Stockbrokers (and others) could buy for customers all the insured certificates of deposit they wished, but they could not, in exchange, receive commissions or other advantages from the banks issuing the certificates. ("Abuse it and lose it," is our motto.)

(vi) The federal regulator would have clear power, exercisable without an excess of "due process" or "second guessing," to close out or force sale or merger of weak banks well before they became insolvent. Banks could ordinarily avoid such calamities, after a first warning, by raising new capital through "rights" issues, or in some other way. (There is nothing novel in such a system. Close-out orders, issued well short of insolvency, have long been standard practice under regulatory practice governing securities and currency traders.)

(vii) Bank accounting for all purposes would count much revenue as profit only after all significant risk had been removed from the transactions generating the revenues. Bank dividends, of course, could be paid only from the more conservatively reported profits. Income tax would be deferred on the deferred revenues required by this new conservatism in accounting. (It is a terrible mistake, a novice's mistake, to try to control important behavior with an all-stick-and-no-carrot approach. Therefore, the carrot-providing tax deferment would be wise.)

(viii) There would be no 2,000-page mass of government regulations. But there would be some rule for business and real estate loans such as: loan as you wish, but no new loans count as bank assets unless supported by substantial equity, a stipulation that would create a large margin of safety.

(ix) Deposit-insurance rates would promptly be lowered from present levels, but under a new system so tough that risk of loss to the deposit insurer would be reduced, even after taking into account the effects from lower rates.

(x) The whole system would be designed to have the best businesses, small and large, again become intimate with the best banks. The banks would again concentrate on being (1) relatively low-interest-rate lenders to high-quality businesses, and (2) lenders to consumers who are not "fiscaholics". High-interest-rate lending, to people with weak credit, would be forced into non-banking systems retaining no common-management or common-premises links with banking.

There is, no doubt, much wrong with our recommendations. But there is also much wrong with our present system, which has helped cause a questionable shift in banking priorities and a big mess, with every prospect for more of the same. In contrast, there is little in history to suggest that our recommendations would be as bad. And even if the new system had serious faults, it would probably be a better way station on the path to a banking system befitting a great country.

In recent years the government has tried to maintain a useful, relatively trouble-free banking system by making the banking business bear increased competitive burdens, and, when the system has responded by working worse, the government has increased both the burdens and the permitted scope of banks' activities. After such revisions the system has again worked worse. Surely it is time to reverse our approach. We should act like the artillery officer who, when he has put one shell over the target, next tries to put a shell clearly short, expecting to get the desired result in due course.

Some people might worry that banking would get too profitable under the system we recommend. To this worry there are three answers:

(1) The prospect of better profits, with less risk, would tend to (a) reduce governmental losses as many billions of dollars worth of foreclosed thrift and bank assets are sold off by the FDIC, and (b) enable the government, through tough capital standards, to cause eager private augmentation of banking capital by shareholders, precisely what is needed.

(2) Based on past experience, the nation's bankers (including us) may, on average, be up to the challenge of not earning excessive profits, even in an easier system.

(3) If excessive profits came, they could easily be reduced in due course by a new governmental tax, charge or burden.

We now quitclaim legislative reform to those who make it their business. We also assure Wesco shareholders that this reform-minded section of our letter to shareholders is an unlikely-to-be-repeated aberration. It was caused, in part, by a combination of (1) overwhelming disgust with the present scene, and (2) long association by the writer with an eccentric fellow who may not share all the notions herein expressed but who encourages this kind of writing.

This eccentric, who heads Berkshire Hathaway, Wesco's parent corporation, believes for some reason that accumulated wealth should *never* be spent on oneself or one's family, but instead should merely serve, before it is given to charity, as an example of a certain approach to life and as a didactic platform. These uses, plus use in building the platform higher, are considered the only honorable ones not only during life but also after death. Shareholders who continue in such peculiar company are hereby warned by our example in writing this section: some of the eccentricities of this fellow are contagious, at least if association is long continued.

Precision Steel

The businesses of Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, contributed $1,985,000 to normal net operating income in 1990, down 28% compared with $2,769,000 in 1989, when earnings were increased by $337,000 through termination of a pension plan. The decrease in 1990 profit occurred as pounds of product sold declined by 3%. Revenues were down slightly more, by 4%, to $57,018,000.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1990 continued, during one more year, to provide an extraordinary return on resources employed.

The good financial results have an underlying reason, although not one strong enough to cause the results achieved in the absence of superb management. Precision Steel's businesses, despite their mundane nomenclature, are steps advanced on the quality scale from mere commodity-type businesses.

It is not common that steel warehouses have results like Precision Steel's. What we see, year after year, under David Hillstrom's leadership is boring, repetitive excellence as he remembers a basic catechism emphasizing service of the highest quality. We hope to remain associated with him for a long time.

Wesco-Financial Insurance Company ("Wes-FIC")

Wes-FIC's "normal" net income for 1990 was $14,924,000, versus $14,276,000 for 1989. The "normal" income figures excluded securities gains, net of income taxes, of $391,000 in 1990 versus $5,910,000 in 1989. These items are reported as "Net Gains on Sales of Securities," below.

At the end of 1990, Wes-FIC retained $68 million in invested assets, offset by claims reserves, from its former reinsurance arrangement with the Fireman's Fund Group. This arrangement was terminated August 31, 1989, but it will take years before all claims are settled. Meanwhile Wes-FIC is helped by proceeds from investing "float."

Wes-FIC has another reinsurance arrangement, patterned after the one with Fireman's Fund, with Cypress Insurance Company, a wholly owned subsidiary of Berkshire Hathaway, Wesco's ultimate parent. Wes-FIC's share of premiums earned under this arrangement was about $1.8 million in 1990. It is too early to forecast how this will work out, but the arrangement is very small and was not nearly so promising at outset as the Fireman's Fund deal, which began at a time when premium rates were being raised by dramatic, double-digit percentages. In contrast, premium rates on virtually all insurance have now been driven down by competition to levels that, at best, will produce small profits, even after including benefit from investing "float."

Wes-FIC is also writing a small amount of direct insurance business, as distinguished from reinsurance. It is licensed in Nebraska, Utah, and Iowa and can write "surplus lines" insurance in Alabama. Total direct premiums earned in 1990 were only $133,000.

Wes-FIC continues to have a "longage" of capital and a shortage of good insurance business. But every year that passes sees Wes-FIC's credit, and that of the Berkshire Hathaway Insurance Group, enhanced relative to the average competing insurer or reinsurer. We expect expansion of earned premiums in due course, made possible by (1) balance sheet strength, (2) a disciplined rejection of under-priced business, combined with quick, non-bureaucratic acceptance of fairly priced risks, and (3) more worry among insurance buyers about claims-paying capacity of competing insurers.

All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, increased to $4,030,000 in 1990 from $3,178,000 in 1989. Sources were (1) rents ($2,647,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant), (2) interest and dividends from cash equivalents and marketable securities held outside the savings and loan and insurance subsidiaries, and (3) earnings of New America Electrical Corporation.

Net Gains On Sales Of Securities

Wesco's aggregate net gains on sales of securities, combined, after income taxes, decreased to $391,000 in 1990 from $5,920,000 in 1989. As noted above, all $391,000 of these gains were realized in the Wes-FIC insurance subsidiary in 1990, versus $5,910,000 realized in 1989.

Convertible Preferred Stockholdings

At the end of 1990, Wesco and its subsidiaries owned $175 million, at cost, in convertible preferred stocks, all requiring redemption at par value within 10 years or so, and all purchased at par value:

Security	Preferred Dividend Rate	Par Value of Holding	Conversion Price at Which Par Value May Be Exchanged for Common Stock	Market Price of Common Stock on 12/31/90
Salomon Inc	9.00%	$100 Million	$38.00	$24.37
The Gillette Company	8.75%	40 Million	50.00	62.75
USAir Group, Inc.	9.25%	12 Million	60.00	15.75
Champion International Corporation	9.25%	23 Million	38.00	25.62

These preferred stocks were purchased at the same time Berkshire Hathaway purchased additional amounts of the same stocks at the same price per share.

Last year we described these convertible preferred stock investments as "sound but not exciting," noting that "few, if any, investors have ever prospered mightily from investing in convertible preferred stocks of leading corporations." Our ideas have not changed. In aggregate these holdings are probably worth a little more than we paid for them (with the Gillette holding now worth more and the USAir holding worth less than was paid for it). Effective April 1, 1991 conversion of the Gillette preferred will be forced, causing us to hold Gillette common stock which pays a much lower annual dividend.

New America Electrical Corporation ("New America Electric")

The financial results from Wesco's $8.2 million payment, made at the end of 1988, for 80% of the stock of New America Electric are included in our residual category: "All Other "Normal" Net Operating Income." New America Electric caused this category to benefit by only $158,000 in 1990 after adjustments under consolidated accounting convention.

Ignoring adjustments under consolidated accounting convention, Wesco's 80% share of New America Electric's earnings was $234,000 in 1990 versus $134,000 in 1989.

Balance sheet liquidity improved. Wesco's 80% share of New America Electric's cash at the end of 1990 was $2.8 million, versus $2 million at the end of 1989.

If you deduct from Wesco's cost ($8.2 million) Wesco's share of cash ($2.8 million), this leaves Wesco at risk for $5.4 million, on which it is earning an inadequate, but improving return.

The people at New America Electric have responded superbly to a difficult environment. It is a pleasure to watch Glen Mitchel, Thomas Vogele, Thomas Johnson and Jeff Mowry meet challenge. They have recently purchased, under terms showing promise, some of the assets, the trade name and the sales organization of another manufacturer of high-quality electrical equipment. And they continue to "shake down" the large new plant into which they recently moved.

Effective at the beginning of 1991, Thomas Vogele, a capable and enthusiastic manager, was promoted to President of New America Electric, assuming responsibility for operations. Glen Mitchel remains heavily involved as CEO. They, and the other executives, face large tasks: (1) incorporating complex, newly acquired product lines into the existing manufacturing base; and (2) generating increased sales of all products, new and old.

Even with the hard tasks ahead, we would not be surprised to see better financial results in 1991 and 1992, despite a recession that is bound to be extra hard on most manufacturers of electrical equipment, dependent as they are on new construction.

Consolidated Balance Sheet and Related Discussion

Wesco's consolidated balance sheet (1) retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others and (2) reflects a continuing slow pace of acquisition of additional businesses because few are found available, despite constant search, at prices deemed rational from the standpoint of Wesco shareholders.

As indicated in the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate carrying value at December 31, 1990 by about $46 million, down significantly from about $98 million one year earlier. The consolidated aggregate market value of all marketable securities, including bonds and other fixed-income securities, exceeded aggregate carrying value by about $61.3 million. As earlier emphasized, about $56.2 million of this unrealized appreciation lies within the savings and loan subsidiary and includes $45.3 million of appreciation in stock of Freddie Mac.

The foregoing paragraph deals only with unrealized appreciation of securities above "carrying value." Wesco also has some unrealized appreciation in securities that is already in "carrying value." This has happened because Wesco's insurance subsidiary at December 31, 1990 had about $40.9 million in appreciation in common stocks (mostly stock of The Coca-Cola Company). Under a peculiar accounting convention applicable only to insurance companies, this appreciation, minus the income

taxes that would be due if the stocks were sold, is already included in Wesco's audited net worth, even though the gain has never passed through any audited report of income.

Wesco's Pasadena real estate comprises a full block containing (1) about 125,000 first-class net rentable square feet, including Mutual Savings' space, in a modern office building, plus (2) an additional net rentable 34,000 square feet of economically marginal space in old buildings, which it would probably be wiser to destroy than improve. This real estate has a market value substantially in excess of carrying value. The existence of unrealized appreciation is demonstrated by (1) mortgage debt ($4,524,000 at 9.25% fixed) against this real estate exceeding its depreciated carrying value ($3,163,000) in Wesco's balance sheet at December 31, 1990, and (2) substantial current net cash flow (about $1 million per year) to Wesco after debt service on the mortgage. The modern office building is 99% rented, despite a glut of vacant office space in Pasadena. We charge just-below-standard rents and run the building as a sort of first-class club for tenants we admire. With these practices, a prime location and superior parking facilities, we anticipate future increases in cash flow, but not in 1991 and 1992. The next two years are not likely to be good years for most owners of commercial real estate.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities. It values its AA+ credit rating.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity requires patience, at least for people like us.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and insurance subsidiaries and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in very few places. Through this practice of concentration of investments, we seek to better understand the few decisions we make.*

The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 12% in 1988-90, was dependent to a significant extent on securities gains, irregular by nature.

When Berkshire Hathaway bought into Wesco in 1973, the present stock (adjusted for a later three-for-one split) traded at about $6. At yearend 1990, the stock traded at $47⅞ and it has paid modest dividends, increased every year, during Berkshire Hathaway's stewardship.

The financial results for Wesco shareholders have not been bad. But they are not outstanding, considering the power of compound interest and the generally favorable business climate. And now,

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* It is interesting to compare Wesco's approach (deliberate non-diversification of investments in an attempt to be more skillful per transaction) with an approach promoted for years by Michael Milken to help sell junk bonds. The Milken approach, supported by theories of many finance professors, argued that (1) market prices were efficient in a world where investors get paid extra for enduring volatility (wide swings in outcomes); (2) therefore, the prices at which new issues of junk bonds came to market were fair in a probabilistic sense (meaning that the high promised interest rates covered increased statistical expectancy of loss) and also provided some premium return to cover volatility exposure; and (3) therefore, if a savings and loan association (or other institution) arranged diversification, say, by buying, without much examination, a large part of each new Milken issue of junk bonds, the association would work itself into the sure to-get-better-than-average-results position of a gambling house proprietor with a "house" edge. This type of theorizing has now wreaked havoc at institutions, governed by true-believers, which backed their conclusions by buying Milken's "bonds." Contrary to the theorizing, widely diversified purchases of such "bonds" have in most cases produced dismal results. We can all understand why Milken behaved as he did and believed what he had to believe in order to maintain an endurable self-image. But how can we explain why anyone else believed that Milken was paid 5% commissions to put "bond" buyers in the position of the house in Las Vegas? We suggest this cause: many of the foolish buyers, and their advisers, were trained by finance professors who pushed beloved models (efficient market theory and modern portfolio theory) way too far, while they ignored other models that would have warned of danger. This is a common type of "expert" error, as we have earlier indicated.

after all these years, Wesco continues to have (1) a *very* strong balance sheet, and (2) a shortage of direct ownership of businesses with enough commercial advantage in place to assure permanent high future returns on capital employed. In contrast, the parent company, Berkshire Hathaway, is better positioned. This outcome was explained in Wesco's annual report last year, to which we refer Wesco shareholders, new and old.

On January 24, 1991, Wesco increased its regular quarterly dividend from 20½ cents per share to 21½ cents per share, payable March 12, 1991, to shareholders of record as of the close of business on February 28, 1991.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Charles T. Munger
Chairman of the Board

March 8, 1991

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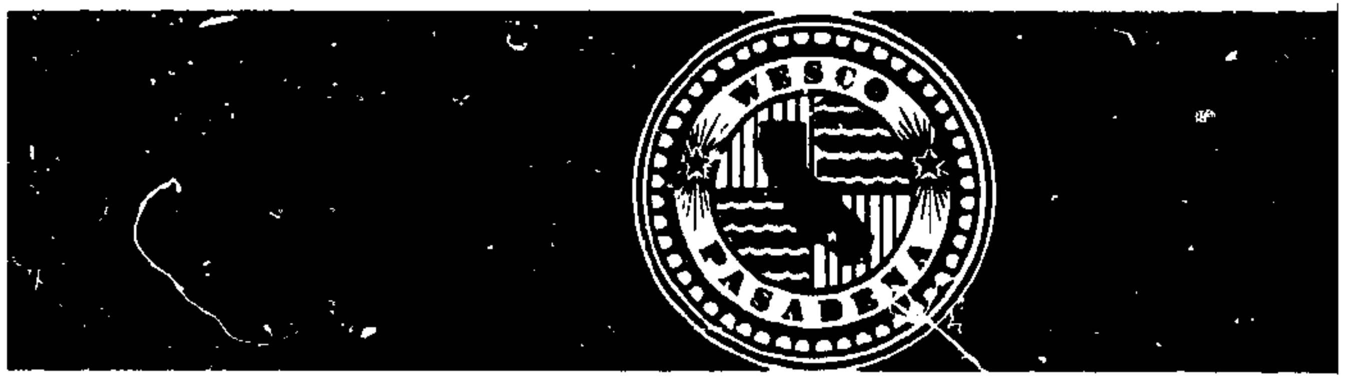

WESCO FINANCIAL CORPORATION

Annual Report 1991

Form 10-K Annual Report 1991

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" operating income (i.e., before all net gains from sales of marketable securities and foreclosed property) for the calendar year 1991 decreased to $22,872,000 ($3.21 per share) from $25,038,000 ($3.52 per share) in the previous year.

Consolidated net income (i.e., after net gains from sales of marketable securities and foreclosed property) increased to $29,522,000 ($4.15 per share) from $25,429,000 ($3.57 per share) in the previous year.

Wesco has three major subsidiaries, Mutual Savings, in Pasadena, Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged principally in the reinsurance business, and Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended			
	December 31, 1991		December 31, 1990	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income of:				
Mutual Savings	$ 3,644	$ .51	$ 4,099	$ .58
Wesco-Financial Insurance business	13,986	1.96	14,924	2.10
Precision Steel's businesses	1,414	.20	1,985	.28
All other "normal" net operating income[2]	3,828	.54	4,030	.56
	22,872	3.21	25,038	3.52
Net gain on sales of marketable securities	5,825	.82	391	.05
Net gain on sales of foreclosed property	825	.12	—	—
Wesco consolidated net income	$29,522	$4.15	$25,429	$3.57

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings headquarters office building, primarily leased to outside tenants, interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries, and the electrical equipment manufacturing business, 80%-owned by Wesco since yearend 1988.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

Mutual Savings

Mutual Savings' "normal" net operating income of $3,644,000 in 1991 represented a decrease of 11% from the $4,099,000 figure the previous year.

As usual, these "normal-income" figures come from an abnormal savings and loan association.

Separate balance sheets of Mutual Savings at yearend 1990 and 1991 are set forth at the end of this annual report. They show (1) total savings accounts increasing to $289 million from the $286 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (near the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, including over $129 million invested in high quality, rapidly maturing mortgage-backed securities, and (4) a loan portfolio (mostly real estate mortgages) of about $101 million at the end of 1991, down moderately from $107 million at the end of 1990.

As pointed out in Note 9 to the accompanying financial statements, the book value of Wesco's equity in Mutual Savings overstates the amount realizable, after taxes, from sale or liquidation at book value. Wesco would get only about $31.3 million, after paying income taxes, from the liquidation at book value of the $48 million portion of Mutual Savings' shareholders' equity which is considered bad debt reserves for income tax purposes. The $3.6 million Mutual Savings earned (ignoring capital gains) in 1991 is an inadequate return (7.6%) on the $48 million amount at which we try to maintain shareholders' equity. It is an even more inadequate return on the somewhat higher amount of capital actually employed within Mutual Savings last year.

The loan portfolio at the end of 1991 bore an average interest rate of only 8.53%, probably the lowest rate on any collection of sound loans in the savings and loan industry. Nonetheless, we believe that the loan portfolio is worth approximately the book value at which it is carried. This appraisal seems right despite some unwise loans we made a couple of years ago, which caused us to reduce carrying value of home loans (and one foreclosed home, so far) by $200,000 in 1991.

Mutual Savings continues cheerfully to make a large number of fixed-rate loans to persons with low-to-moderate income, frequently in minority groups. We loan at below-market interest rates, intending to suffer considerable disadvantage as a matter of community service. But last year we couldn't suffer much disadvantage, despite our best efforts, because interest rates continually declined, making our inventory of loans in process rise in value. Next year we will do better at obtaining the disadvantage we seek, causing a worse outcome for shareholders. We will sell off most of these fixed-rate loans above a "pipe-line" inventory, because we don't like the interest-rate risks implicit in a loan-and-hold policy.

Generally (meaning without effect from unusual sources), Mutual Savings' future earning power during the short-term future has been impaired, exactly as we predicted, by recent revisions in savings and loan laws generally known under the acronym: "FIRREA".

Prodded by FIRREA, all Mutual Savings' preferred stocks in public utility companies have been sold at a considerable profit, and its $26 million holding of Salomon Inc convertible preferred stock (with a tax-equivalent yield of 12.6%) has been transferred at cost to another Wesco subsidiary. Soon, all extra-high-yielding assets

will be gone. Meanwhile, regulatory costs have increased, and deposit-insurance costs will increase after exhaustion of a temporary exemption now in place. Short-term, this will probably lower our return on capital employed. But, long term, we will probably get back all the extra-high-tax-equivalent yield we once had, and more. This will happen if Federal Home Loan Mortgage Corporation ("Freddie Mac") continues to increase the dividend on our large holding of its stock as it last did a few days before this letter was written.

Moreover, despite FIRREA, Mutual Savings has reasonable prospects for doing much better than "all right" for a considerable number of years, because of potential assistance from two unusual sources.

A first (and small) source of potential assistance is the probability that we will make an overall profit, despite occasional quarterly losses, from disposition of foreclosed Santa Barbara real estate. This profit is now expected to be somewhat lower than the $12 million in unrealized land appreciation which we believe existed before we started development. The factors which have caused continuous reductions in our profit expectation are (1) the delays and indignities, even larger and more costly than expected, imposed by local laws, and (2) slow sales of houses and lots as California receives, for a change, more than its pro-rata share of a nationwide recession.

A second (and large) source of potential assistance is the probability that we will eventually realize gains from sales of portions of Mutual Savings' holding of 2,400,000 shares of Freddie Mac, traded on the New York Stock Exchange. At year-end 1991, Mutual Savings' carrying value of this holding was $71.7 million, and the unrealized pre-tax appreciation was $258.3 million. If Mutual Savings' Freddie Mac holdings had been liquidated at market value on December 31, 1991, the after-tax profit would have been about $152.1 million, or $21.37 per Wesco share outstanding.

As we have stated in previous annual reports, Freddie Mac has a much better basic business than Mutual Savings. That is why we did the logical thing and redeployed capital to reflect realities. Freddie Mac and its rough equivalent, "Fannie Mae," now perform most of the former function of the savings and loan industry in support of essential housing.

We continue to expect future changes in banking and savings and loan laws, combined with continuing troubles in many insured institutions, including some large ones. In such a climate, we continually explore expansion-by-acquisition options for Mutual Savings. We are not restricted to planning for a reasonable sort of future on the assumption that no large expansion will prove feasible.

Precision Steel

The businesses of Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, contributed $1,414,000 to normal net operating income in 1991, down 29% compared with $1,985,000 in 1990. The decrease in

1991 profit occurred as pounds of product sold increased 12%. Revenues were up only 1% to $57,484,000, reflecting the pounding which competition gave to prices.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1991 handled a strong recessionary downdraft with skill. Profits were lower because of tough conditions, not poor management.

Wesco-Financial Insurance Company ("Wes-FIC")

Wes-FIC's "normal" net income for 1991 was $13,986,000, versus $14,924,000 for 1990. The "normal" income figures excluded securities gains, net of income taxes, of $391,000 in 1990 versus none in 1991. These items are reported as "Net Gains on Sales of Securities," below.

At the end of 1991 Wes-FIC retained $54 million in invested assets, offset by claims reserves, from its former reinsurance arrangement with the Fireman's Fund Group. This arrangement was terminated August 31, 1989, but it will take years before all claims are settled. Meanwhile Wes-FIC is helped by proceeds from investing "float."

The rest of Wes-FIC's insurance business is disappointingly small, but we continue to explore various options.

All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, decreased to $3,828,000 in 1991 from $4,030,000 in 1990. Sources were (1) rents ($2,801,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant), (2) interest and dividends from cash equivalents and marketable securities held outside the savings and loan and insurance subsidiaries, and (3) results from New America Electrical Corporation.

Net Gains On Sales Of Securities

Wesco's aggregate net gains on sales of securities, combined, after income taxes, increased to $5,825,000 in 1991 from $391,000 in 1990. All the gains last year were realized by Mutual Savings, in sales forced by FIRREA.

Convertible Preferred Stockholdings

At the end of 1991, Wesco and its subsidiaries owned $135 million, at cost, in convertible preferred stocks, all requiring redemption at par value within 10 years or so from date of acquisition, all at par value:

Security	Preferred Dividend Rate	Par Value of Holding	Conversion Price at which Par Value may be Exchanged for Common Stock	Market Price of Common Stock on 12/31/91
Salomon Inc	9.00%	$100 Million	$38.00	$30.62
USAir Group, Inc.	9.25%	12 Million	52.35	12.12
Champion International Corporation	9.25%	23 Million	38.00	24.00

These preferred stocks were purchased at the same time Wesco's parent corporation, Berkshire Hathaway, purchased additional amounts of the same stocks at the same price per share.

In a previous year we described these convertible preferred stock investments as "sound but not exciting," noting that "few, if any, investors have ever prospered mightily from investing in convertible preferred stocks of leading corporations." Our ideas have not changed. In aggregate our remaining holdings are probably worth a little less than we paid for them. (We estimate that (1) the $12 million USAir holding is now worth about 35% less than was paid for it, (2) the $100 million Salomon holding is worth about 2% more than we paid for it, and (3) the $23 million Champion holding is worth about cost.) More than offsetting an overall shrinkage in value of retained holdings which is quite minor ($2.2 million), we last year converted a $40 million holding of Gillette convertible preferred stock into Gillette common stock worth $89.8 million at year end. See comments below under the title "Consolidated Balance Sheet and Related Discussion."

New America Electrical Corporation ("New America Electric")

The financial results from Wesco's $8.2 million payment, made at the end of 1988, for 80% of the stock of New America Electric are included in our residual category: "All Other "Normal" Net Operating Income." New America Electric caused this category to lose $40,000 in 1991 after adjustments under consolidated accounting convention.

Ignoring adjustments under consolidated accounting convention, Wesco's 80% share of New America Electric's earnings was $36,000 in 1991 versus $234,000 in 1990.

Balance sheet liquidity declined slightly. Wesco's 80% share of New America Electric's cash at the end of 1991 was $2.5 million, versus $2.8 million at the end of 1990, — but New America purchased a new line of business last year, which more than accounts for the small reduction in cash.

If you deduct from Wesco's cost ($8.2 million) Wesco's share of cash ($2.5 million), that leaves Wesco at risk for $5.7 million, on which it is earning an inadequate return.

The people at New America Electric continue to respond superbly to a difficult environment, the worst since the 1930s, in commercial construction. It remains a pleasure to watch Glen Mitchel, Thomas Vogele, John Medel and Jeff Mowry meet challenge.

Consolidated Balance Sheet and Related Discussion

Wesco's consolidated balance sheet (1) retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others and (2) reflects a continuing slow pace of acquisition of additional businesses because

few are found available, despite constant search, at prices deemed rational from the standpoint of Wesco shareholders.

As indicated in the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate carrying value at December 31, 1991 by about $259 million, up significantly from about $55 million one year earlier. The consolidated aggregate market value of all marketable securities, including bonds and other fixed-income securities, exceeded aggregate carrying value by about $263 million. As earlier emphasized, about $258 million of this unrealized appreciation lies within the savings and loan subsidiary in the form of appreciation in stock of Freddie Mac.

The foregoing paragraph deals only with unrealized appreciation of securities above "carrying value." Wesco also has some unrealized appreciation in securities that is already in "carrying value." This has happened because Wesco's insurance subsidiary at December 31, 1991 had about $153 million in appreciation in common stocks (mostly stocks of The Coca-Cola Company and The Gillette Company). Under a peculiar accounting convention applicable only to insurance companies, this appreciation, minus the income taxes that would be due if the stocks were sold, is already included in Wesco's audited net worth, even though the gain has never passed through any audited report of income.

Wesco's Pasadena real estate comprises a full block containing (1) about 125,000 first-class net rentable square feet, including Mutual Savings' space in a modern office building, plus (2) an additional net rentable 34,000 square feet of economically marginal space in old buildings, which it would probably be wiser to destroy than improve. Despite a sharp, nationwide reduction in value for office buildings, this real estate retains some market value in excess of carrying value. The existence of unrealized appreciation is demonstrated by (1) mortgage debt ($4,394,000 at 9.25% fixed) against this real estate exceeding its depreciated carrying value ($3,365,000) in Wesco's balance sheet at December 31, 1991, and (2) substantial current net cash flow (about $1 million per year) to Wesco after debt service on the mortgage. The modern office building is 99% rented, despite a glut of vacant office space in Pasadena. We charge just-below-standard rents and run the building as a sort of first-class club for tenants we admire. Even with these rational-but-not-very-common practices, a prime location and superior parking facilities, we no longer anticipate increases in cash flow during the next five years. We will catch some share of bad effects from glut conditions in the office building segment of the commercial real estate market, no matter how rationally we manage our building.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities. It values its AA+ credit rating.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity requires patience, at least for people like us whose valuable insights are few.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and insurance subsidiaries and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in very few places. Through this practice of concentration of investments, we seek to better understand the few decisions we make.

The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 11% in 1989-91, was dependent to a significant extent on securities gains, irregular by nature.

On January 23, 1992, Wesco increased its regular quarterly dividend from 21½ cents per share to 22½ cents per share, payable March 12, 1992, to shareholders of record as of the close of business on February 28, 1992.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Charles T. Munger
Chairman of the Board

March 9, 1992

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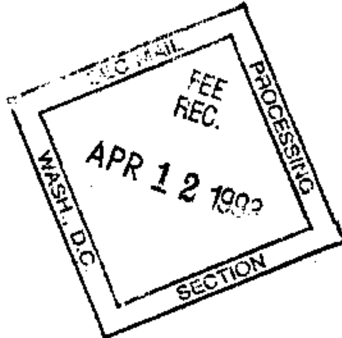
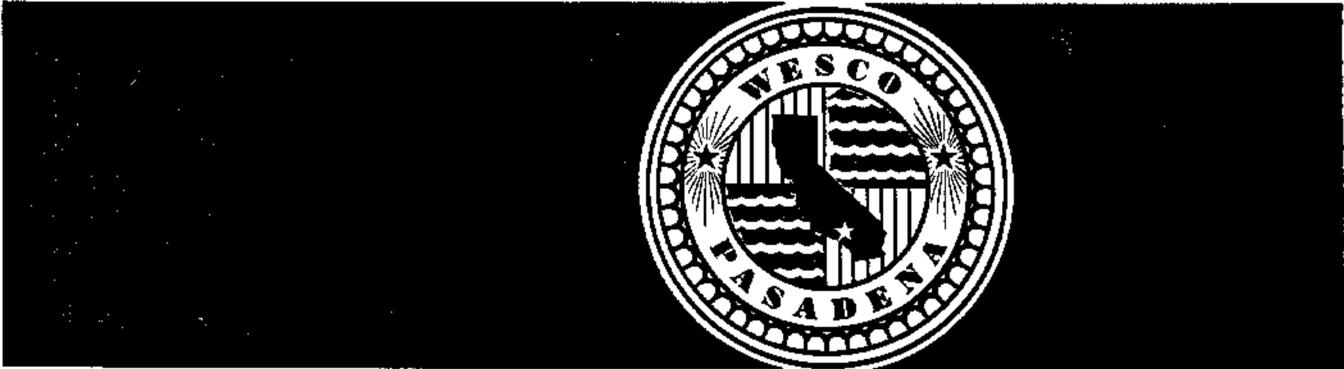




WESCO FINANCIAL CORPORATION

Annual Report 1992

Form 10-K Annual Report 1992

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" net operating income (i.e., before all net gains or losses from sales of marketable securities and foreclosed property and unusual charges associated with a proposed give-up of Mutual Savings' status as a regulated savings and loan association) for the calendar year 1992 decreased to $22,500,000 ($3.16 per share) from $22,872,000 ($3.21 per share) in the previous year.

Consolidated net income (i.e., after net gains or losses from sales of marketable securities and foreclosed property and unusual income tax charges associated with the proposed give-up of Mutual Savings' status as a regulated savings and loan association) decreased to $5,001,000 ($.70 per share) from $29,522,000 ($4.15 per share) in the previous year.

Wesco has three major subsidiaries: Mutual Savings, currently engaged in the savings and loan business in Pasadena, Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged principally in the reinsurance business, and Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended			
	December 31, 1992		December 31, 1991	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income of:				
Mutual Savings	$ 3,746	$ .52	$ 3,644	$ .51
Wesco-Financial Insurance business	13,146	1.85	13,986	1.96
Precision Steel's businesses	2,075	.29	1,414	.20
All other "normal" net operating income[2]	3,533	.50	3,828	.54
	22,500	3.16	22,872	3.21
Net gain on sales of marketable securities	147	.02	5,825	.82
Net gain (loss) on sales of foreclosed property	(146)	(.02)	825	.12
Charges associated with the proposed give-up of Mutual Savings' status as a regulated savings and loan association[3]	(17,500)	(2.46)	—	—
Wesco consolidated net income	$ 5,001	$ .70	$29,522	$4.15

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings headquarters office building, primarily leased to outside tenants, interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries, and the electrical equipment manufacturing business, 80%-owned by Wesco since yearend 1988.

(3) Consists of income tax provision on about $47 million of Mutual Savings' net worth considered bad debt reserve for income tax (not financial statement) purposes, required to be recorded at 1992 yearend as a result of the decision to give up Mutual Savings' status as a regulated savings and loan association and thereby trigger recapture, for income tax purposes, of the bad debt reserve.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The

supplementary breakdown is furnished because it is considered useful to shareholders.

Mutual Savings

We have decided that Mutual Savings will shortly give up its status as a regulated savings and loan association. To achieve this objective, Mutual Savings is negotiating to sell to another financial institution, subject to regulatory approval, the leaseholds and related tangible personal property necessary to operate Mutual Savings' deposit-gathering offices. We expect that the buyer will assume all deposits and receive cash and other assets amounting, at Mutual Savings' book value, to slightly less than Mutual Savings' book value for the deposits assumed. After provision for costs, including some employee-severance payments, Wesco will probably report in 1993 a modest after-tax gain from the sale, measured from a point after the unusual income tax charge from bad debt reserve recapture in 1992.

At roughly the same time, Mutual Savings will transfer its real estate (including but not limited to its Santa Barbara seaside property) to a newly formed Wesco subsidiary which will thereafter manage the real estate and make such dispositions as seem appropriate.

After these transactions, Mutual Savings will retain a majority (at market value) of its former assets (consisting mostly of stock of Federal Home Loan Mortgage Corporation ["Freddie Mac"] and indirect loans in the form of securitized mortgages). Mutual Savings will then be merged into another long-existing Wesco subsidiary, Wesco-Financial Insurance Company, which will thereafter continue the portion of Mutual Savings' business that in recent years has employed the majority of its assets. However, the continuation of this business, including investment in mortgages, will be regulated by the Nebraska Department of Insurance, replacing the many different state and federal officials who now govern institutions like Mutual Savings.

We anticipate that future operating costs of the merged business will be very much lower than Mutual Savings' present costs as a heavily regulated institution. At the same time, asset deployment options will be greatly increased.

The 1992 earnings figures of Wesco include an unusual charge of $17.5 million caused by our decision to leave the regulatory scheme governing savings and loan associations. The figure consists of income tax provision on the $47 million of Mutual Savings' shareholders' equity that has never heretofore been taxed because it has been considered a bad debt reserve for income tax purposes.

Under conservative and reasonable accounting principles, when we first firmly planned to discontinue qualifying for that special bad-debt-reserve tax treatment which is given only to regulated savings and loan associations, we were required to accrue income tax provision as we have.

The financial impact on Wesco shareholders of the large new income tax provision at yearend 1992 is likely to be minimally negative over the short term and

positive over the long term. After all, there are practical advantages in moving hundreds of millions of dollars of assets (at market value) from a high-cost, low-flexibility environment to a low-cost, high-flexibility environment.

Separate balance sheets of Mutual Savings at yearend 1991 and 1992 are set forth at the end of this annual report. They show (1) total savings accounts decreasing to $251 million from $289 million the year before and (2) a very high ratio of shareholders' equity to savings account liabilities (near the highest for any mature U.S. savings and loan association) even after the unusual 1992 yearend income tax charge of $17.5 million.

We reserved $200,000 for loan losses in 1991 and $650,000 more in 1992. These provisions constitute the only loan losses recorded in over a decade. They were caused by some bonehead errors we made in 1988-89, combined with the effects of the worst Southern California real estate recession in many years. On loans made after 1989, experience has reverted to wonderful.

Our prediction of future profit from disposition of foreclosed Santa Barbara seaside property goes down every year. Last year was no exception, but we still expect a small eventual profit, amounting approximately to compound interest on capital employed over the long development period.

At yearend 1992, Mutual Savings' carrying value of its holding of Freddie Mac common stock, traded on the New York Stock Exchange, was $71.7 million. The unrealized pre-tax appreciation was $276.6 million. If Mutual Savings' Freddie Mac holdings had been liquidated at market value on December 31, 1992, the after-tax profit would have been about $162.4 million, or $22.82 per Wesco share outstanding.

As we have stated in previous annual reports, Freddie Mac has a much better basic business than Mutual Savings. That is why we did the logical thing and redeployed capital to reflect realities. Freddie Mac and its rough equivalent, "Fannie Mae," now perform most of the former function of the savings and loan industry in support of essential housing.

Precision Steel

The businesses of Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, contributed $2,075,000 to normal net operating income in 1992, up 47% compared with $1,414,000 in 1991. The increased 1992 profit was achieved in spite of a 2% decrease in pounds of product sold, and was attributable largely to some favorable quantity-order prices on steel purchased and a change in mix of product. Revenues were up only 1% to $58,048,000.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1992 continued, during one more year, to provide an extraordinary return on resources employed.

Wesco-Financial Insurance Company ("Wes-FIC")

Wes-FIC's net income for 1992 was $13,146,000, versus $13,986,000 for 1991.

At the end of 1992 Wes-FIC retained $45 million in invested assets, offset by claims reserves, from its former reinsurance arrangement with the Fireman's Fund Group. This arrangement was terminated August 31, 1989, but it will take years before all claims are settled. Meanwhile Wes-FIC is helped by proceeds from investing "float."

Wes-FIC entered into another reinsurance arrangement in 1992 with National Indemnity Company ("NICO"), a wholly owned subsidiary of Berkshire Hathaway, Wesco's ultimate parent, whereby NICO retroceded to it 50% of certain personal lines reinsurance it had assumed. This arrangement was responsible for almost the entire $19.6 million of Wes-FIC's earned premiums for 1992.

After Wes-FIC's capital and claims-paying capacity have been greatly augmented by the merger into Wes-FIC of Mutual Savings, Wes-FIC plans, through subcontracts with the Berkshire Hathaway Insurance Group, to enter the business of super-catastrophe ("super-cat") reinsurance. In such event, we believe: (1) Wes-FIC will thereafter report earnings with very wide fluctuations as it sometimes gets hit by big losses caused by super-catastrophes such as 1992's Hurricane Andrew and sometimes realizes large underwriting profits in years in which no super-catastrophes occur, and (2) Wes-FIC will thereafter have somewhat improved prospects for long-term prosperity.

All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, decreased to $3,533,000 in 1992 from $3,828,000 in 1991. Sources were (1) rents ($2,816,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant), (2) interest and dividends from cash equivalents and marketable securities held outside the savings and loan and insurance subsidiaries, and (3) results from New America Electrical Corporation.

Net Gains on Sales of Securities

Wesco's aggregate net gains on sales of securities, combined, after income taxes, decreased to $147,000 in 1992 from $5,825,000 in 1991. All the gains were realized by Mutual Savings. Those realized in 1991 resulted from sales forced by Federal regulation.

Convertible Preferred Stockholdings

At the end of 1992, Wesco and its subsidiaries owned $135 million, at cost, in convertible preferred stocks, all requiring redemption at par value within ten years or so from date of acquisition:

Security	Preferred Dividend Rate	Par Value of Holding	Conversion Price at Which Par Value May Be Exchanged for Common Stock	Market Price of Common Stock on 12/31/92
Salomon Inc	9.00%	$100 Million	$38.00	$38.12
USAir Group, Inc.	9.25%	12 Million	44.28	12.75
Champion International Corporation	9.25%	23 Million	38.00	28.75

These preferred stocks were purchased at the same time Wesco's parent corporation, Berkshire Hathaway, purchased additional amounts of the same stocks at the same price per share.

In a previous year we described these convertible preferred stock investments as "sound but not exciting," noting that "few, if any, investors have ever prospered mightily from investing in convertible preferred stocks of leading corporations." Our ideas have not changed. In aggregate our holdings are probably worth a little more than we paid for them. We estimate that (1) the $100 million Salomon holding is worth about 8% more than we paid for it, (2) the $12 million USAir holding is now worth about 25% less than was paid for it, and (3) the $23 million Champion holding is worth about 3% more than we paid for it. These figures when combined create $5.7 million in net appreciation at the 1992 yearend, attributable principally to the effect that the general decline in interest rates has had on values of fixed-rate investments.

New America Electrical Corporation ("New America Electric")

The financial results from Wesco's $8.2 million payment, made at the end of 1988, for 80% of the stock of New America Electric are included in our residual category: "All Other 'Normal' Net Operating Income." New America Electric caused this category to lose $195,000 in 1992, up from a loss of $40,000 in 1991, after adjustments under consolidated accounting convention.

Ignoring adjustments under consolidated accounting convention, Wesco's 80% share of New America Electric's loss was $119,000 in 1992 versus income of $36,000 in 1991.

Balance sheet liquidity remained steady. Wesco's 80% share of New America Electric's cash at the end of 1992 remained unchanged from the $2.5 million reported at the end of 1991.

If you deduct from Wesco's cost ($8.2 million) Wesco's share of cash ($2.5 million), this leaves Wesco at risk for $5.7 million, on which it is earning an inadequate return.

The people at New America Electric continue to respond superbly to a difficult environment, the worst since the 1930s in commercial construction. It remains a pleasure to be associated with Glen Mitchel, John Medel and Jeff Mowry.

Consolidated Balance Sheet and Related Discussion

As indicated in the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate carrying value at December 31, 1992 by about $278 million, up moderately from about $259 million one year earlier. The consolidated aggregate market value of all marketable securities, including bonds and other fixed-income securities, exceeded aggregate carrying value by about $280 million. As earlier emphasized, $276.6 million of this unrealized appreciation lies within the savings and loan subsidiary in the form of appreciation in stock of Freddie Mac. None of the foregoing figures includes the net unrealized appreciation, per our appraisal, of $5.7 million in our holdings of convertible preferred stocks.

The foregoing paragraph deals only with unrealized appreciation of securities above "carrying value." Wesco also has some unrealized appreciation in securities that is already in "carrying value." This has happened because Wesco's insurance subsidiary at December 31, 1992 had about $163 million in appreciation in common stocks (mostly stocks of The Coca-Cola Company and The Gillette Company). Under a peculiar accounting convention applicable only to insurance companies, this appreciation, minus the income taxes that would be due if the stocks were sold, is already included in Wesco's audited net worth, even though the gain has never passed through any audited report of income.

Under this same peculiar accounting convention applicable only to insurance companies, Wesco's audited consolidated net worth is about to go up sharply. This will happen because unrealized appreciation in Freddie Mac stock, after provision for income tax as if sold, will count as net worth after Mutual Savings has been merged out of the savings and loan system and into the Wes-FIC insurance business. Sophisticated Wesco shareholders will not take this accounting quirk very seriously.

Wesco's Pasadena real estate comprises a full block containing (1) about 125,000 first-class net rentable square feet, including Mutual Savings' space, in a modern office building, plus (2) an additional net rentable 34,000 square feet of economically marginal space in old buildings, which it would probably be wiser to destroy than improve. Despite a sharp, nationwide reduction in value for office buildings, this real estate retains some market value in excess of carrying value. The existence of unrealized appreciation is demonstrated by (1) mortgage debt ($4,251,000 at 9.25% fixed) against this real estate exceeding its depreciated carrying value ($3,446,000) in Wesco's balance sheet at December 31, 1992, and (2) substantial current net cash flow (about $750 thousand per year) to Wesco after debt service on the mortgage. The modern office building is 97% rented, despite a glut of vacant office space in Pasadena. We charge just-below-standard rents and run the building as a sort of first-class club for tenants we admire. Even with these

rational-but-not-very-common practices, a prime location and superior parking facilities, we no longer anticipate increases in cash flow during the next five years. Instead, we expect continuing modest decreases. We are catching some share of bad effects from glut conditions in the office building segment of the commercial real estate market.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities. It values its AA+ credit rating. Indeed, it hopes to get the best credit rating possible, only one notch up, after giving up status as a savings and loan holding company.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity has been slow because our valuable insights are few.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and insurance subsidiaries and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in very few places. Through this practice of concentration of investments, we seek to better understand the few decisions we make.

The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 7% in 1990-92 (9% before the unusual income tax charge of $17.5 million relating to the proposed give-up of Mutual Savings' status as a regulated savings and loan association), was dependent to a significant extent on securities gains, irregular by nature.

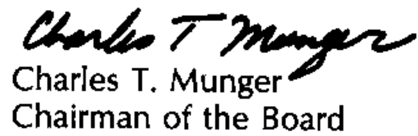
Wesco's record looks much better when changes in unrealized appreciation of marketable securities (held principally in its savings and loan and insurance subsidiaries) are taken into account. For instance, compare status at yearends 1989 and 1992:

	Book Value of Common Equity, Before Any Unrealized Appreciation in Marketable Securities	Unrealized Appreciation, Before Any Provision for Income Tax, in Marketable Securities
1989	$262 million	$127 million
1992	$304 million	$441 million

Wesco, as it manages its affairs, makes no effort to remove fluctuations, even extreme fluctuations, from reported earnings. All it cares about are long-term results.

On January 28, 1993, Wesco increased its regular quarterly dividend from 22½ cents per share to 23½ cents per share, payable March 10, 1993, to shareholders of record as of the close of business on February 11, 1993.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.



Charles T. Munger
Chairman of the Board

March 25, 1993

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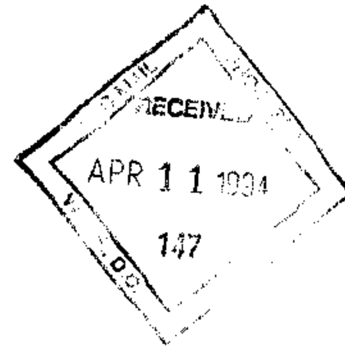

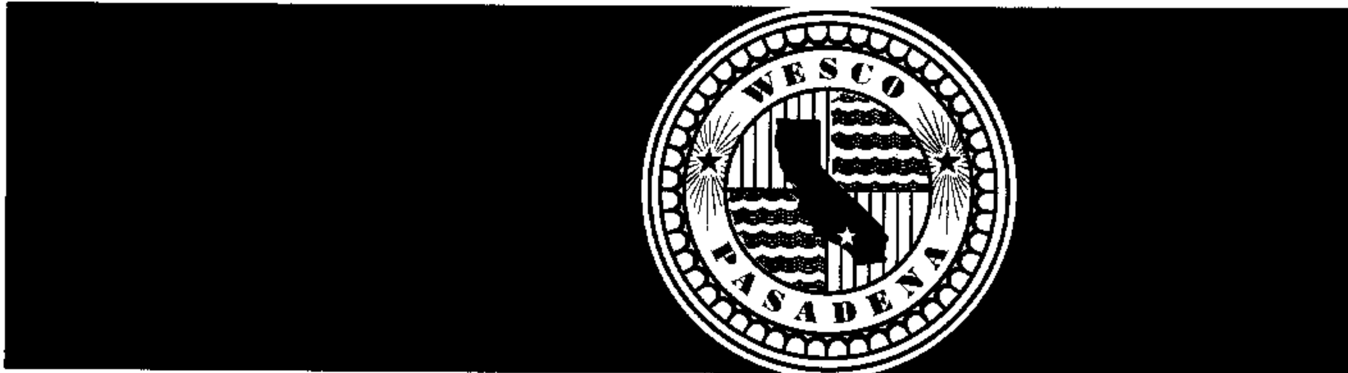

WESCO FINANCIAL CORPORATION

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Annual Report 1993

Form 10-K Annual Report 1993

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" net operating income (i.e., before irregularly occurring items shown in the table below) for the calendar year 1993 decreased to $20,382,000 ($2.87 per share) from $22,500,000 ($3.16 per share) in the previous year.

Consolidated net income (i.e., after irregularly occurring items shown in the table below) increased to $19,718,000 ($2.77 per share) from $5,001,000 ($.70 per share) in the previous year.

Wesco in 1993 had three major subsidiaries: Mutual Savings, engaged until late in the year in the savings and loan business in Pasadena, Wesco-Financial Insurance Company, headquartered in Omaha and engaged principally in the reinsurance business, and Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended			
	December 31, 1993		December 31, 1992	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income of:				
Mutual Savings	$ 2,458	$ .35	$ 3,746	$ .52
Wesco-Financial Insurance business	12,434	1.75	13,146	1.85
Precision Steel's businesses	2,189	.31	2,075	.29
All other "normal" net operating income[2]	3,301	.46	3,533	.50
	20,382	2.87	22,500	3.16
Net gain on sales of marketable securities	1,156	.16	147	.02
Net loss on sales of foreclosed property	—	—	(146)	(.02)
Unusual income tax charges	(1,109)[3]	(.16)	(17,500)[4]	(2.46)
Gain on disposition of Mutual Savings' deposits and some loans	906	.13	—	—
Loss on disposition of approximately 80% interest in New America Electrical Corporation	(1,617)	(.23)	—	—
Wesco consolidated net income	$19,718	$2.77	$ 5,001	$ .70

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses. Income was from ownership of the Wesco and Mutual Savings headquarters office building, primarily leased to outside tenants, interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries, and the electrical equipment manufacturing business, 80%-owned by Wesco through June 30, 1993.

(3) Consists principally of effect of tax rate change on deferred tax on unrealized appreciation of marketable equity securities.

(4) Consists of income tax provision on about $47 million of Mutual Savings' net worth considered bad debt reserve for income tax (not financial statement) purposes, required to be recorded at 1992 yearend as a result of the decision to give up Mutual Savings' status as a regulated savings and loan association and thereby trigger recapture, for income tax purposes, of the bad debt reserve.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

Mutual Savings and its Successors

On October 8, 1993, Mutual Savings closed the sale covered by its contract, previously made and announced, with CenFed Bank ("CENFED"), a highly regarded, insured institution also headquartered in Pasadena. In part, this buyer had been chosen to take over Mutual Savings' offices because it was considered likely to serve depositors safely and well.

In the closing of the transaction, Mutual Savings transferred to CENFED that part of Mutual Savings' liabilities (principally insured deposit liabilities) which was causing Mutual Savings to pay substantial deposit-insurance premiums in exchange for remaining a highly regulated savings and loan association. Also transferred to CENFED were some mortgage loans and a large amount of cash offset by deposits assumed.

At roughly the same time, Mutual Savings transferred certain troubled assets to a newly organized Wesco subsidiary that will conduct a slow liquidation of those assets. The transferred assets were:

(1) the unsold residue (with a book value of $23.1 million) of Mutual Savings' now-slow-selling residential real estate project, created in an attempt to maximize proceeds from foreclosed mostly-seaside land in the Montecito district of Santa Barbara, California, plus

(2) other foreclosed real estate with an aggregate book value of $8.2 million, plus

(3) seven troubled first mortgage loans on houses, with an aggregate book value of $1.9 million.

Then, a little later, Mutual Savings, now removed by the CENFED transaction from savings and loan regulation, merged into Wesco's long-existing Omaha-domiciled insurance subsidiary, Wesco-Financial Insurance Company ("Wes-FIC"), thus causing continuation of Mutual Savings' business and continued business holding of its main assets by Wes-FIC. Assets thus transferred incident to the merger with Wes-FIC consisted mostly of $45.8 million (at book value) in high quality mortgage-backed securities plus 7.2 million shares of Federal Home Loan Mortgage Corporation ("Freddie Mac") with a cost of $71.7 million and a market value of $359.1 million (based on the 1993 yearend NYSE quotation of $49.87 per Freddie Mac share).

Accordingly, 1993 was the last year in which Wesco will report any earnings from the savings and loan business. In 1994 and thereafter roughly all former savings and loan business earning power will augment reported results of Wesco's Wes-FIC subsidiary, now greatly enlarged in net worth.

As the table showing sources of income indicates, Mutual Savings got creditably through its last year, contributing $2.5 million to normal net operating income, down 34% from $3.7 million in 1992. A $2.0 million pre-tax writedown in the fourth quarter of the residue of Mutual Savings' Montecito residential real estate project caused almost all of the 1993 reduction in income.

In addition, an after-tax gain of $906,000 ($.13 per Wesco share) was realized in the transaction between Mutual Savings and CENFED. As part of this transaction Wesco loaned CENFED's parent corporation $4 million for three years at a market rate of interest and made some guarantees of loan quality. Also, CENFED leased from Wesco for 15 years at a market rental rate the groundfloor space formerly occupied by Mutual Savings in Wesco's retained building, formerly named the "Mutual Savings Building" and now renamed the "CenFed Bank Building" pursuant to terms of the lease. And, later, the building was transferred by Wesco to its new California real estate subsidiary.

The building, with its new name, is shown in the photograph at the front of this annual report. (We were proud of the economical old photograph, used successively over so many years that all the automobile models therein had eventually disappeared from the earth, but we finally shot a new photograph after the savings and loan charter, as well as the automobile models, had vanished from the scene.)

Because all failures and faults deserve extra attention in annual reports, we hereby state for the second time that it is not only Wes-FIC which has succeeded to former assets of Mutual Savings. As indicated above, Wesco now has a new real estate subsidiary that, mostly, it does not want. The subsidiary, named MS Property Company, will hereafter both (1) hold and operate Wesco's office and parking property in Pasadena, California and (2), as we said above, liquidate the $33.2 million (at yearend 1993 book value) of assets neither transferred to CENFED nor left in Mutual Savings when it was merged into Wes-FIC. The liquidation part of the game will occur in a poor climate for liquidations. The California real estate crash has been no small crash, and it has taken a large toll on values. Our best guess is that Wesco will eventually (and slowly) realize, from all real estate assets of MS Property Company combined, (1) more than present book value but (2) less than present book value plus a market rate of interest, after corporate taxes.

Generally, real estate holding, and even real estate development, when conducted in publicly held corporate form, subject to corporate income taxes, has a very poor record for serving shareholders well. This occurs because the real estate game, in which most market values are set in transactions involving people who are not paying corporate income taxes and many of whom pay virtually no taxes at all, is not ordinarily lucrative enough to create a decent return for persons in the same game, disadvantaged by a level of corporate taxes. We have no antidote for the share of this general investment disadvantage now being borne by Wesco shareholders.

Shareholders who wonder why tag-end real estate assets from the past should now bedevil a small percentage of Wesco's future will not find the experience reassuring as they appraise management. In retrospect, it appears (1) that some

troubles — from poor loan quality — came because the writer was not paying enough attention and (2) that a more devoted approach didn't work very well either as troubles — from the slow-selling residential real estate project in Montecito — came because the writer gave too much effort and attention, even going so far as to create in the project a personal house now worth considerably less than he paid for it in cash, much of which went to Mutual Savings under firm-price conditions it would very much like to see again.

However, the writer does not wish to go too far in wearing a hair shirt. All things weighed, Mutual Savings' record was not so bad, and its Montecito project will some years hence be recognized as a minor, one-of-a-kind, extremely creditable place, reflecting well on its creators. Moreover, it seems to the writer that any patient person who now buys a needed residence therein is virtually sure to come out quite well. **Accordingly, every Wesco shareholder who is a prospective user of a Montecito residence is hereby invited to consider buying into our project.**

A last word on Mutual Savings is now appropriate in requiem. Many Wesco shareholders have an income tax basis of only a few pennies (or less) per Wesco share and are related to respected founders. All the value they now own in their Wesco shares has eventually come from a tiny savings and loan association carried through a tough 1930s economic climate by these founders, long ago. Under such circumstances, heightened by a prideful remembrance of much service to California housing, some tinge of regret is inevitable for these shareholders and, indeed, even for shareholders like Berkshire Hathaway that came in much later. But we make no apology for changing course. In our view, Freddie Mac, which has low costs and pays no deposit insurance premiums, is a much better business than Wesco had in its heavily regulated savings and loan operation, and Wesco did the logical thing as it deployed Mutual Savings' assets and momentum to the better Freddie Mac business.

Precision Steel

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, contributed $2,189,000 to normal net operating income in 1993, compared with $2,075,000 in 1992. Sales increased from $58,048,000 to $60,127,000.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1993 continued to provide a fine return on resources employed.

Wesco-Financial Insurance Company ("Wes-FIC")

Wes-FIC's normal net income for 1993 was $12,434,000, down slightly from $13,146,000 for 1992.

At the end of 1993 Wes-FIC retained about $39.3 million in invested assets, offset by claims reserves, from its former reinsurance arrangement with Fireman's Fund Group. This arrangement was terminated August 31, 1989. However, it will

take a long time before all claims are settled, and, meanwhile, Wes-FIC is being helped over many years by proceeds from investing "float."

As reported last year, Wes-FIC in 1992 entered into another reinsurance arrangement with National Indemnity Company ("NICO"), a wholly owned subsidiary of Berkshire Hathaway, Wesco's ultimate parent, whereby NICO retroceded to Wes-FIC 50% of certain personal lines reinsurance it had assumed. This arrangement was responsible for almost the entire $12.2 million of Wes-FIC's earned premiums for 1993. However, it terminated during 1993 because the original source of the reinsurance stopped making cessions to NICO.

In last year's annual report we informed shareholders that Wes-FIC planned, through reinsurance to be retroceded by Berkshire Hathaway, to enter the business of super-catastrophe ("super-cat") reinsurance in late 1993 or 1994. This would occur after Wes-FIC's net worth and claims-paying capacity had been greatly augmented by the proposed merger (which has now happened) of Wesco's former savings and loan subsidiary into Wes-FIC.

The super-cat reinsurance business then seemed a very logical business for Wes-FIC. After all, Wes-FIC would have a large net worth in relation to annual premiums being earned. And this is exactly the condition rationally required for any insurance company planning to become a "stand alone" reinsurer covering super-catastrophe risks it can't safely pass on to others sure to remain solvent if a large super-catastrophe comes. Such a "stand alone" reinsurer must be a kind of Fort Knox, prepared occasionally, without calling on any other reinsurers for help, to pay out in a single year many times more than premiums coming in, as it covers losses from some super catastrophe worse than Hurricane Andrew. In short, it needs a balance sheet a lot like Wes-FIC's.

Unfortunately, after issuance of Wesco's 1992 Annual Report, other reinsurers, as 1993 progressed, hurried more and more into the super-cat field. As a consequence, volumes of super-cat reinsurance business available to NICO at prices that seemed rational were greatly reduced.

Under such circumstances of shortage at NICO of acceptable super-cat business, we later told shareholders (in the third quarter report) that NICO would probably have no surplus super-cat reinsurance business to cede to Wes-FIC.

In connection with the retrocessions of super-cat reinsurance from NICO to Wes-FIC the nature of the situation as it has evolved is such that Berkshire Hathaway, owning 100% of NICO and only 80% of Wesco and Wes-FIC, is not, for some philanthropic reason, ordinarily going to retrocede to Wes-FIC any reinsurance business that Berkshire Hathaway considers desirable and that is available only in amounts below what Berkshire Hathaway wants for itself on the terms offered. Instead, retrocessions will occur only occasionally, under limited conditions and with some compensation to Berkshire Hathaway. Such retrocessions will ordinarily happen only (1) when Berkshire Hathaway, for some reason (usually a policy of overall risk limitation) desires lower amounts of business than are available on the

terms offered and (2) Wes-FIC has adequate capacity to bear the risk assumed and (3) Wes-FIC pays a fair ceding commission designed to cover part of the cost of getting and managing insurance business.

Generally, Berkshire Hathaway, in dealing with partly owned subsidiaries, tries to lean over a little backward in an attempt to observe what Justice Cardozo called "the punctilio of an honor the most sensitive," but it cannot be expected to make large and plain giveaways of Berkshire Hathaway assets or business to a partially owned subsidiary like Wes-FIC.

Given Berkshire Hathaway's unwillingness to make plain giveaways to Wes-FIC and the 1993 reductions in opportunities in the super-cat reinsurance market, it appeared until very recently that we were right in the 1993 third quarter report in projecting poor prospects over the near term for Wes-FIC's acquisition of retroceded super-cat reinsurance. But what are the predictions of man! In February 1994, Wes-FIC was offered by NICO participations in four *very* unusual super-cat reinsurance contracts. Considering its other exposures to the same risks, NICO was willing to retrocede to Wes-FIC 20% of what was then available to NICO under each contract in return for a ceding commission amounting to 3% of Wes-FIC's premiums to be received. The remaining 80% of the risk was to be retained by NICO. A little later, a fifth retrocession was offered: 10% of a one-year NICO property loss contract with a maximum loss amount of $50 million. The annual premium is 5% of the maximum possible loss.

Wes-FIC promptly accepted all of these five unusual super-cat reinsurance participations offered by NICO.

In the first four contracts, in aggregate, Wes-FIC thus became exposed, during a single year, to either winning about $4 million pre-tax or losing about $20 million pre-tax. In addition, there is some slight possibility of a huge "long tail" loss for Wes-FIC and NICO many years after the four contracts end, because a minority part of the insurance is liability insurance written on an "occurrence" basis. This is not the first time such "long tail" risks have been accepted by Wes-FIC. There are also, it should be remembered, possibilities for unpleasant surprises involving similar possible large "long tail" losses, many years hence, from Wes-FIC's long-terminated reinsurance arrangement with Fireman's Fund Group. Wes-FIC, now as then, is willing to run such "long tail" risks, carefully weighed against prospects for gain, provided it is much better capitalized than other insurance companies more influenced by animal spirits and institutional momentums.

In the fifth super-cat retrocession to Wes-FIC from NICO, which covers only property loss, there is no possibility of a surprising "long tail" loss. However, for the year covered, Wes-FIC has a very small chance of losing $5 million pre-tax, while it can gain only $250,000, less 3%, leaving Wes-FIC's net proceeds $242,500, pre-tax.

Needless to say, NICO does not believe that the average yearly loss to be expected from writing over many years a great series of super-cat reinsurance contracts like the five new ones it has retroceded in part to Wes-FIC would be as

high as the one-year premiums to be received. But such super-cat reinsurance, like other super-cat reinsurance, is not for the faint of heart. A huge variation in annual results, with some *very* unpleasant years, is inevitable.

But it is precisely what must, in the nature of things, be associated with these bad possibilities, with their huge and embarrassing adverse consequences in occasional years, that makes Wes-FIC like its way of being in the super-cat business. Buyers (particularly wise buyers) of super-cat reinsurance often want to deal with wholly owned Berkshire Hathaway subsidiaries (possessing as they do the highest possible credit ratings and a reliable corporate personality) instead of other reinsurers less cautious, straightforward and well endowed. And many competing sellers of super-cat reinsurance are looking for a liberal "intermediary's" profit, hard to get because they must find a "layoff" seller both (1) so smart that it is sure to stay strong enough to pay possible losses yet (2) so casual about costs that it is not much bothered by a liberal profit earned by some intermediary entity not willing to retain any significant risk. Thus the forces in place can rationally be expected to cause acceptable long-term results for well-financed, disciplined decision makers, despite horrible losses in some years and other years of restricted opportunity to write business. And, again, we wish to repeat that we expect *acceptable* long-term results. We see no possibility for bonanza.

It should also be noted that Wes-FIC, in the arrangements recently made with NICO, receives a special business-acquisition advantage from using Berkshire Hathaway's better credit rating and general reputation. Under all the circumstances, a 3% ceding commission seems more than fair to Wes-FIC. Certainly and obviously, Berkshire Hathaway would not offer terms so good to any other entity outside the Berkshire Hathaway affiliated group.

Finally, an important word about Wes-FIC's super-cat-reinsurance-acquisition mechanics. It is impractical to have people in California make complex accept-or-reject decisions for Wes-FIC when retrocessions of reinsurance are offered by Berkshire Hathaway insurance subsidiaries. But, happily, the Berkshire Hathaway insurance group executives making original business-acquisition decisions are greatly admired and trusted by the writer and will be "eating their own cooking." Under such circumstances, Wesco's and Wes-FIC's boards of directors, on the writer's recommendation, have simply approved automatic retrocessions of reinsurance to Wes-FIC as offered by one or more wholly owned Berkshire Hathaway subsidiaries. Each retrocession is to be accepted forthwith in writing in Nebraska by agents of Wes-FIC who are at the same time salaried employees of wholly owned subsidiaries of Berkshire Hathaway. Moreover, each retrocession will be made at a 3%-of-premiums ceding commission. Finally, two conditions must be satisfied: (1) Wes-FIC must get 20% or less of the risk (before taking into account effects from the ceding commission) and (2) wholly owned Berkshire Hathaway subsidiaries must retain at least 80% of the identical risk (again, without taking into account effects from the ceding commission).

We will not ordinarily describe individual super-cat reinsurance contracts in full detail to Wesco shareholders. That would be contrary to our competitive interest. Instead, we will try to summarize reasonably, more or less as we have done here.

Will more reinsurance be later available to Wes-FIC through Berkshire Hathaway subsidiaries on the basis and using the automatic procedure we have above described? Well, we have already proved poor prognosticators. We can only say that we hope so and that more reinsurance should come, albeit irregularly and with long intermissions, if buyers of super-cat coverage are rational.

We have also examined other possible insurance-writing opportunities, and even insurance company acquisitions, not involving Berkshire Hathaway.

Wes-FIC is now a very strong insurance company, with very low costs, and, one way or another, in the future as in the past, we expect to continue to find and seize at least a few sensible insurance opportunities.

All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, decreased to $3,301,000 in 1993 from $3,533,000 in 1992. Sources were (1) rents ($2,848,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office property (predominantly leased to outsiders and with CENFED as the new ground floor tenant), (2) interest and dividends from cash equivalents and marketable securities held outside the savings and loan and insurance subsidiaries, and (3) results from New America Electrical Corporation until its disposition.

Net Gains on Sales of Securities

Wesco's aggregate net gains on sales of securities, combined, after income taxes, increased to $1,156,000 in 1993 from $147,000 in 1992.

Convertible Preferred Stockholdings

At the end of 1993, Wesco and its subsidiaries owned $135 million, at cost, in convertible preferred stocks, all requiring redemption at par value within ten years or so from date of acquisition:

Security	Preferred Dividend Rate	Par Value of Holding	Conversion Price at Which Par Value May Be Exchanged for Common Stock	Market Price Common Stock on 12/31/93
Salomon Inc	9.00%	$100 Million	$38.00	$47.63
USAir Group, Inc.	9.25%	12 Million	38.74	12.88
Champion International Corporation	9.25%	23 Million	38.00	33.38

These preferred stocks were purchased at the same time Wesco's parent corporation, Berkshire Hathaway, purchased additional amounts of the same stocks at the same price per share.

In previous years we described these convertible preferred stock investments as "sound but not exciting," noting that "few, if any, investors have ever prospered mightily from investing in convertible preferred stocks of leading corporations." Our ideas have not changed. But in aggregate our holdings at yearend 1993 were worth more than we paid for them. We estimate that (1) the $100 million Salomon holding was worth about 25% more than we paid for it, (2) the $12 million USAir holding was worth about 25% less than we paid for it, and (3) the $23 million Champion holding was worth about 5% more than we paid for it. These figures when combined created $23.1 million in net appreciation, before taxes, at the 1993 yearend.

New America Electrical Corporation ("New America Electric")

It was not just Wesco's savings and loan privileges that left our corporate fold in 1993. New America Electric, of which Wesco has owned about 80% since 1988, sold its business last year to a long-established and high-quality midwestern firm engaged in similar businesses. During 1993, Wesco's share of net loss was $192,000 for the six-month period preceding sale of the business, and Wesco realized an additional after-tax loss of $1.6 million ($.23 per Wesco share) on final disposition of its interest.

The sale decision was made entirely by Glen Mitchel, New America Electric's CEO and 20% owner, who did not wish to wait for an eventual upturn in commercial construction after years of enduring a worst-since-the-1930s business climate to which he had adjusted through several painful downsizings. The bad timing of Wesco in entering the electrical equipment field when it did was entirely the result of misjudgment by the writer, caused by a strong, near-lifelong preference for predicting relative consequences from business and human quality while not attempting to predict business cycles.

Considering the very hostile business climate we later encountered, New America Electric's business was always run extremely well by Glen Mitchel, and his dedication and skill prevented us from losing much more than we did. The writer caused Wesco's loss, not Glen Mitchel.

Consolidated Balance Sheet And Related Discussion

As indicated in the accompanying financial statements, Wesco increased its net worth, as accountants compute it under their conventions, from $411.7 million at yearend 1992 to $626.1 million at yearend 1993.

This increase in reported net worth happened only in very small measure ($13.0 million) because of retention of 1993 income after deduction of dividends paid. Virtually the entire balance of the 1993 net worth increase occurred through accounting quirk and without real economic import, because (1) before 1993 only unrealized appreciation in equity securities of the Wes-FIC insurance subsidiary, after provision for income taxes to become due if the securities were sold, was included in Wesco's reported consolidated net worth, leaving all other securities valued at cost, whereas (2) in 1993, due to changed notions in accounting, all of

Wesco's consolidated unrealized appreciation in equity securities was given the same accounting treatment formerly in place at the Wes-FIC insurance subsidiary.

Even after the new accounting notions were applied, the result at yearend 1993 still leaves out of Wesco's consolidated net worth of $626.1 million a residue of unrealized appreciation — in Wesco's consolidated holdings of non-equity securities. This residue of unrealized appreciation exists almost entirely in Wesco's convertible preferred stocks, and, after tax provision, amounted to about $15.2 million more.

If this additional $15.2 million were added to the $626.1 million of Wesco's consolidated net worth reported at yearend 1993, the resulting figure of $641.3 million, or about $90 per Wesco share, would give an approximation of Wesco's after-tax liquidation value at yearend 1993.

The foregoing liquidation value figure is based on the assumption that all Wesco's non-security assets would liquidate, after taxes, at book value. Probably, this assumption is too conservative, making our computation of approximate after-tax liquidation value slightly too low. But our computation is unlikely to be too low by more than a couple of dollars per Wesco share, because (1) the liquidation value of Wesco's consolidated real estate holdings (where interesting potential lies almost entirely in Wesco's equity in its office and parking property in Pasadena, plus the residue of Wesco's residential real estate project in Montecito) is now far below its former high, and (2) unrealized appreciation in other assets (primarily Precision Steel) cannot be large enough, in relation to Wesco's overall size, to change very much the overall computation of after-tax liquidating value.

Of course, so long as Wesco does not liquidate, and does not sell any appreciated assets, it has, in effect, an interest-free "loan" from the government equal to its deferred income taxes on unrealized gains, subtracted in determining its net worth. This interest-free "loan" from the government is at this moment working for Wesco shareholders and amounted to about $24 per Wesco share at yearend 1993.

However, some day, perhaps soon, major parts of the interest-free "loan" must be paid as assets are sold. Therefore, Wesco's shareholders have no perpetual advantage creating value for them of $24 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than $24 per Wesco share. In the writer's judgment, the value of Wesco's advantage from its temporary, interest-free "loan" was probably about $8 per Wesco share at yearend 1993.

After the value of the advantage inhering in the interest-free "loan" is estimated, a reasonable approximation can be made of Wesco's intrinsic value per share. This approximation is made by simply adding (1) the value of the advantage from the interest-free "loan" per Wesco share and (2) liquidating value per Wesco share. Others may think differently, but the foregoing approach seems reasonable to the writer as a way of estimating intrinsic value per Wesco share.

Thus, if the value of the advantage from the interest-free tax-deferral "loan" present was $8 per Wesco share at yearend 1993, and after-tax liquidating value was then about $92 per share (figures that seem plenty high to the writer), Wesco's intrinsic value per share would become only about $100 per share at yearend 1993.

And, finally, this reasonable-to-this-writer, $100-per-share-figure for intrinsic per share value of Wesco stock should be compared with the $129.50 per share price at which Wesco stock was selling on December 31, 1993. This comparison indicates that Wesco stock was then selling about 30% above intrinsic value.

There are, to be sure, at least some circumstances where presence of some superior management in place at some corporation as large as Wesco would rationally justify an investor's payment of so large a premium over intrinsic value. It may even be remotely conceivable that the market's present implicit optimistic appraisal of Wesco's managerial quality will be justified by outcomes to follow. But it may also be that new buyers of Wesco stock are making a mistake similar to the one that would be made if the past performance of a very old NFL quarterback, including some performance that occurred long ago, was projected as likely to indicate long-term performance to come.

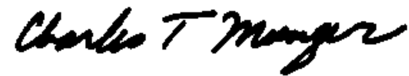
It has never been the writer's view that the unvarying duty of management is to whoop up the stock price. Instead, the duty is to "tell-it-like-it-is." Now, for some reason, perhaps the relative novelty of our approach, our "tell-it-like-it-is" attitude seems to be a contributing factor in pushing Wesco's stock price up — perhaps even higher than it would be if we followed the more normal whoop-it-up policy.

As part of a "tell-it-like-it-is" policy we now report that some recent Wesco stock-buying enthusiasm plainly has irrational roots. Indeed, some people have gone so far as to suggest that Wesco stock is a better buy than stock of Berkshire Hathaway because Wesco is smaller or because Wesco's stock price per share is lower. Such reasoning processes constitute arrant nonsense in method. Also nonsensical is the notion that business and human quality in place at Wesco is anywhere near as good, all factors considered, as that in place at Berkshire Hathaway. Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco plainly provides much less intrinsic value than a similar dollar of book value at Berkshire Hathaway.

All that said, we make no attempt to appraise relative attractiveness for investment of Wesco vs Berkshire Hathaway stock at present stock-market quotations. Instead, we simply communicate, out of a feeling of duty, the writer's opinion that more caution is probably needed in some quarters as prospects for new buyers of Wesco stock are evaluated.

On January 26, 1994 Wesco increased its regular dividend from 23½ cents per share to 24½ cents per share, payable March 9, 1994, to shareholders of record as of the close of business on February 9, 1994.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.



Charles T. Munger
Chairman of the Board

March 23, 1994

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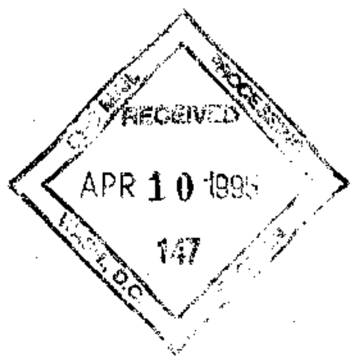
P.E. 12-31-94



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WESCO FINANCIAL CORPORATION

Annual Report 1994

Form 10-K Annual Report 1994

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" net operating income (i.e., before irregularly occurring items shown in the table below) for the calendar year 1994 increased to $24,659,000 ($3.46 per share) from $20,382,000 ($2.87 per share) in the previous year.

Consolidated net income (i.e., after irregularly occurring items shown in the table below) decreased to $18,972,000 ($2.66 per share) from $19,718,000 ($2.77 per share) in the previous year.

Wesco in 1994 had two major subsidiaries: Wesco-Financial Insurance Company ("Wes-FIC"), headquartered in Omaha and engaged principally in the reinsurance business and in indirect real estate lending following its statutory merger with Mutual Savings on January 1, 1994, and Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended			
	December 31, 1994		December 31, 1993	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income of:				
Wes-FIC business	$21,582	$3.03	$12,434	$1.75
Precision Steel businesses	2,900	.40	2,189	.31
Mutual Savings	—	—	2,458	.35
All other "normal" net operating income[2]	177	.03	3,301	.46
	24,659	3.46	20,382	2.87
Gain on sales of marketable securities	163	.02	1,156	.16
Decline in value of USAir preferred stock	(5,850)[3]	(.82)	—	—
Unusual income tax charges	—	—	(1,109)[4]	(.16)
Gain on disposition of Mutual Savings' deposits and some loans	—	—	906	.13
Loss on disposition of 80% interest in New America Electrical Corporation	—	—	(1,617)	(.23)
Wesco consolidated net income	$18,972	$2.66	$19,718	$2.77

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses and, in 1994, costs and expenses associated with delinquent loans and foreclosed real estate previously charged against Mutual Savings. Income was from ownership of the Wesco headquarters office building, primarily leased to outside tenants, interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries, and the electrical equipment manufacturing business, 80%-owned by Wesco through June 30, 1993.

(3) Represents writedown of investment in preferred stock of USAir Group, Inc., explained in section "Convertible Preferred Stockholdings" below.

(4) Consists principally of effect of tax rate change on deferred tax on unrealized appreciation of investments.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

Mutual Savings and its Successors

On October 8, 1993, Mutual Savings closed the sale covered by its contract, previously made and announced, with CenFed Bank ("CENFED"), a highly regarded, insured institution also headquartered in Pasadena. In part, this buyer had been chosen to take over Mutual Savings' offices because it was considered likely to serve depositors safely and well.

In the closing of the transaction, Mutual Savings transferred to CENFED that part of Mutual Savings' liabilities (principally insured deposit liabilities) which was causing Mutual Savings to pay substantial deposit-insurance premiums in exchange for remaining a highly regulated savings and loan association. Also transferred to CENFED were some mortgage loans and a large amount of cash offset by deposits assumed.

At roughly the same time, Mutual Savings transferred certain troubled assets to MS Property Company ("MS Property"), a newly organized Wesco real estate subsidiary that is slowly liquidating those assets. The 1994 yearend balances on MS Property's books of those transferred assets were:

(1) the unsold residue (with a book value of $18.8 million) of Mutual Savings' now-slow-selling residential real estate project, created in an attempt to maximize proceeds from foreclosed mostly-seaside land in the Montecito district of Santa Barbara, California, plus

(2) other foreclosed real estate and troubled first mortgage loans on houses, with a combined book value of $8.3 million.

On January 1, 1994, after its transfer of troubled assets to MS Property, Mutual Savings merged into Wesco's long-existing Omaha-domiciled insurance subsidiary, Wes-FIC, thus causing continuation of Mutual Savings' business and continued business holding of its main assets by Wes-FIC. Assets thus transferred incident to the merger with Wes-FIC consisted mostly of 7.2 million shares of Federal Home Loan Mortgage Corporation ("Freddie Mac") with a cost of $71.7 million and a 1994 yearend market value of $363.6 million (based on the 1994 yearend NYSE quotation of $50.50 per Freddie Mac share), plus approximately $30 million of high quality mortgage-backed securities.

Accordingly, 1993 was the last year in which Wesco reported any earnings from the savings and loan business. Beginning in 1994 roughly all former savings and loan business earning power augments reported results of Wesco's Wes-FIC subsidiary, now greatly enlarged in net worth.

An after-tax gain of $906,000 ($.13 per Wesco share) was realized in the transaction between Mutual Savings and CENFED. As part of this transaction Wesco loaned CENFED's parent corporation $4 million for three years at a market rate of interest and made some guarantees of loan quality. Also, CENFED leased from Wesco for 15 years at a market rental rate the ground floor space formerly occupied by Mutual Savings in Wesco's retained headquarters building, formerly named the "Mutual Savings Building" and now renamed the "CenFed Bank Building" pursuant to terms of the lease. And, later, the building was transferred by Wesco to MS Property.

The building, with its new name, is shown in the photograph at the front of this annual report.

Because all failures and faults deserve extra attention in annual reports, we hereby repeat what we emphasized last year: It is not only Wes-FIC that has succeeded to former assets of Mutual Savings. As indicated above, Wesco still retains a recently formed real estate subsidiary that, mostly, it does not want. The subsidiary, MS Property, both (1) holds and operates Wesco's office and parking property in Pasadena, California and (2) continues liquidation of the $27.1 million (at yearend 1994 book value) of assets heretofore described that were neither transferred to CENFED nor left in Mutual Savings when it was merged into Wes-FIC. The liquidation part of the game is occurring in a poor climate for liquidations. The California real estate crash has been no small crash, and it has taken a large toll on values. MS Property took a $3.0 million pre-tax writedown of the residue of Mutual Savings' Montecito residential real estate project during 1994, following a $2.0 million pre-tax writedown taken by Mutual Savings in 1993. Our best guess is that Wesco will eventually (and slowly) realize, from all real estate assets of MS Property combined, (1) more than present book value (after the two writedowns) but (2) less than such present book value plus interest imputed at a market rate, after corporate taxes.

Generally, real estate holding, and even real estate development, when conducted in publicly held corporate form, subject to corporate income taxes, has a very poor record for serving shareholders well. This occurs because the real estate game, in which most market values are set in transactions involving people who are not paying corporate income taxes and many of whom pay virtually no taxes at all, is not ordinarily lucrative enough to create a decent return for persons in the same game, disadvantaged by a level of corporate taxes. We continue to have no antidote for the share of this general investment disadvantage now being borne by Wesco shareholders. But, fortunately, it affects only a very small percentage of Wesco's consolidated assets.

Precision Steel

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, contributed $2,900,000 to normal net operating income in 1994, compared with $2,189,000 in 1993.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1994 continued to provide an excellent return on resources employed.

Wesco-Financial Insurance Company ("Wes-FIC")

Wes-FIC's normal net income for 1994 was $21,582,000, up significantly from $12,434,000 for 1993. The earnings on the assets contributed in the merger with Mutual Savings at the beginning of 1994 were responsible for the greater part of this increase.

At the end of 1994 Wes-FIC retained about $35 million in invested assets, offset by claims reserves, from its former reinsurance arrangement with Fireman's Fund Group. This arrangement was terminated August 31, 1989. However, it will take a long time before all claims are settled, and, meanwhile, Wes-FIC is being helped over many years by proceeds from investing "float."

In last year's annual report we informed shareholders that Wes-FIC had entered into the business of super-catastrophe ("super-cat") reinsurance through retrocessions from National Indemnity Company ("NICO"), a wholly owned insurance company subsidiary of Berkshire Hathaway, Wesco's ultimate parent. Wes-FIC's entry into the super-cat reinsurance business followed the large augmentation of its claims-paying capacity caused by its merger with Mutual Savings. In 1994, in recognition of Wes-FIC's sound financial condition, Standard and Poor's Corporation assigned to Wes-FIC the highest possible claims-paying-ability rating: AAA.

The super-cat reinsurance business continues to be a very logical business for Wes-FIC. After all, Wes-FIC has a large net worth in relation to annual premiums being earned. And this is exactly the condition rationally required for any insurance company planning to be a "stand alone" reinsurer covering super-catastrophe risks it can't safely pass on to others sure to remain solvent if a large super-catastrophe comes. Such a "stand alone" reinsurer must be a kind of Fort Knox, prepared occasionally, without calling on any other reinsurers for help, to pay out in a single year many times more than premiums coming in, as it covers losses from some super catastrophe worse than Hurricane Andrew. In short, it needs a balance sheet a lot like Wes-FIC's.

In connection with the retrocessions of super-cat reinsurance from NICO to Wes-FIC the nature of the situation as it has evolved is such that Berkshire Hathaway, owning 100% of NICO and only 80% of Wesco and Wes-FIC, is not, for some philanthropic reason, ordinarily going to retrocede to Wes-FIC any reinsurance business that Berkshire Hathaway considers desirable and that is available only in amounts below what Berkshire Hathaway wants for itself on the terms offered. Instead, retrocessions will occur only occasionally, under limited conditions and with some compensation to Berkshire Hathaway. Such retrocessions will ordinarily happen only (1) when Berkshire Hathaway, for some reason (usually a policy of overall risk limitation) desires lower amounts of business than are available on the terms offered and (2) Wes-FIC has adequate capacity to bear the risk assumed and

(3) Wes-FIC pays a fair ceding commission designed to cover part of the cost of getting and managing insurance business.

Generally, Berkshire Hathaway, in dealing with partly owned subsidiaries, tries to lean over a little backward in an attempt to observe what Justice Cardozo called "the punctilio of an honor the most sensitive," but it cannot be expected to make large and plain giveaways of Berkshire Hathaway assets or business to a partially owned subsidiary like Wes-FIC.

Given Berkshire Hathaway's unwillingness to make plain giveaways to Wes-FIC and reductions in opportunities in the super-cat reinsurance market in recent years, prospects are often poor for Wes-FIC's acquisition of retroceded super-cat reinsurance. Nonetheless, in February 1994, Wes-FIC was offered by NICO participations in four very unusual super-cat reinsurance contracts. Considering its other exposures to the same risks, NICO was willing to retrocede to Wes-FIC 20% of what was then available to NICO under each contract in return for a ceding commission amounting to 3% of Wes-FIC's premiums to be received. The remaining 80% of the risk was to be retained by NICO. A little later, a fifth retrocession was offered: 10% of a one-year NICO property loss contract with a maximum loss amount of $50 million. The annual premium is 5% of the maximum possible loss. Then, in June, a sixth contract became available.

Wes-FIC promptly accepted all of these six unusual super-cat reinsurance participations offered by NICO.

In the first four contracts, in aggregate, Wes-FIC thus became exposed, during a single year, to either winning about $4 million pre-tax or losing about $20 million pre-tax. In addition, there is some slight possibility of a huge "long tail" loss for Wes-FIC and NICO many years after the four contracts end, because a minority part of the insurance is liability insurance written on an "occurrence" basis. This is not the first time such "long tail" risks have been accepted by Wes-FIC. There are also, it should be remembered, possibilities for unpleasant surprises involving similar possible large "long tail" losses, many years hence, from Wes-FIC's long-terminated reinsurance arrangement with Fireman's Fund Group. Wes-FIC, now as then, is willing to run such "long tail" risks, carefully weighed against prospects for gain, provided it is much better capitalized than other insurance companies more influenced by animal spirits and institutional momentums.

In the fifth super-cat retrocession to Wes-FIC from NICO, which covers only property loss, there is no possibility of a surprising "long tail" loss. However, for the year covered, Wes-FIC has a very small chance of losing $5 million pre-tax, while it can gain only $250,000, less 3%, leaving Wes-FIC's net proceeds $242,500, pre-tax.

In the sixth retrocession from NICO, Wes-FIC is participating to the extent of 5% in a $400 million contract with 20th Century Industries, a California insurer currently attempting to recover from devastating effects of the Northridge, California earthquake. The amount of reinsurance under the contract (covering what is mostly earthquake risk) is declining monthly over the term, expiring early in 1995, as 20th

Century withdraws from the homeowners and earthquake insurance markets in California. Wes-FIC could earn a premium of approximately $1 million in 1995 under the contract.

Needless to say, NICO does not believe that the average yearly loss to be expected from writing over many years a great series of super-cat reinsurance contracts like those it has retroceded in part to Wes-FIC would be as high as the one-year premiums to be received. But such super-cat reinsurance, like other super-cat reinsurance, is not for the faint of heart. A huge variation in annual results, with some very unpleasant years, is inevitable.

But it is precisely what must, in the nature of things, be associated with these bad possibilities, with their huge and embarrassing adverse consequences in occasional years, that makes Wes-FIC like its way of being in the super-cat business. Buyers (particularly wise buyers) of super-cat reinsurance often want to deal with wholly owned Berkshire Hathaway subsidiaries (possessing as they do the highest possible credit ratings and a reliable corporate personality) instead of other reinsurers less cautious, straightforward and well endowed. And many competing sellers of super-cat reinsurance are looking for a liberal "intermediary's" profit, hard to get because they must find a "layoff" reinsurer both (1) so smart that it is sure to stay strong enough to pay possible losses yet (2) so casual about costs that it is not much bothered by a liberal profit earned by some intermediary entity not willing to retain any significant risk. Thus the forces in place can rationally be expected to cause acceptable long-term results for well-financed, disciplined decision makers, despite horrible losses in some years and other years of restricted opportunity to write business. And, again, we wish to repeat that we expect only acceptable long-term results. We see no possibility for bonanza.

It should also be noted that Wes-FIC, in the arrangements recently made with NICO, receives a special business-acquisition advantage from using Berkshire Hathaway's general reputation. Under all the circumstances, a 3% ceding commission seems more than fair to Wes-FIC. Certainly and obviously, Berkshire Hathaway would not offer terms so good to any other entity outside the Berkshire Hathaway affiliated group.

Finally, we repeat an important disclosure about Wes-FIC's super-cat-reinsurance-acquisition mechanics. It is impractical to have people in California make complex accept-or-reject decisions for Wes-FIC when retrocessions of reinsurance are offered by Berkshire Hathaway insurance subsidiaries. But, happily, the Berkshire Hathaway insurance group executives making original business-acquisition decisions are greatly admired and trusted by the writer and will be "eating their own cooking." Under such circumstances, Wesco's and Wes-FIC's boards of directors, on the writer's recommendation, have simply approved automatic retrocessions of reinsurance to Wes-FIC as offered by one or more wholly owned Berkshire Hathaway subsidiaries. Each retrocession is to be accepted forthwith in writing in Nebraska by agents of Wes-FIC who are at the same time salaried employees of wholly owned subsidiaries of Berkshire Hathaway. Moreover, each retrocession will be made at a

3%-of-premiums ceding commission. Finally, two conditions must be satisfied: (1) Wes-FIC must get 20% or less of the risk (before taking into account effects from the ceding commission) and (2) wholly owned Berkshire Hathaway subsidiaries must retain at least 80% of the identical risk (again, without taking into account effects from the ceding commission).

We will not ordinarily describe individual super-cat reinsurance contracts in full detail to Wesco shareholders. That would be contrary to our competitive interest. Instead, we will try to summarize reasonably, more or less as we have done here.

Will more reinsurance be later available to Wes-FIC through Berkshire Hathaway subsidiaries on the basis and using the automatic procedure we have above described? Well, we have often proved poor prognosticators. We can only say that we hope so and that more reinsurance should come, albeit irregularly and with long intermissions, if buyers of super-cat coverage are rational.

We continue to examine other possible insurance-writing opportunities, and also insurance company acquisitions, not involving Berkshire Hathaway.

Wes-FIC is now a very strong insurance company, with very low costs, and, one way or another, in the future as in the past, we expect to continue to find and seize at least a few sensible insurance opportunities.

On super-cat reinsurance accepted by Wes-FIC to date (March 9, 1995) there has been no loss whatsoever that we know of. However, no underwriting profit flowed through Wesco's books in 1994 because none of its super-cat contracts expired in 1994, and our accounting policy requires contract expiration before super-cat underwriting profit is recognized. Needless to say, we would not have similar reticence to report losses before contract expirations. Our super-cat accounting policy is not irrationally super-conservative, although it may amount to "best-practice" accounting.

All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, decreased to $177,000 in 1994 from $3,301,000 in 1993. Sources were (1) rents ($3,050,000 gross) from Wesco's Pasadena office property (leased almost entirely to outsiders and with CENFED as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiary, mostly offset in 1994 by certain costs and expenses that had not previously been charged against this category — namely, the costs and expenses of liquidating the delinquent loans and foreclosed real estate, including additions to loss reserves, that in prior years had been charged against Mutual Savings. The 1994 figure also includes an intercompany charge for interest expense ($826,000 after taxes) on borrowings from Wes-FIC made late in 1993 principally to facilitate the transfer of loans and foreclosed properties to MS Property. This intercompany *interest expense* does not affect Wesco's consolidated net income

inasmuch as the same amount is included as *interest income* in Wes-FIC's normal net operating income.

Net Securities Gains and Losses

Wesco's earnings in 1994 contain securities gains of $163,000, after income taxes, and also reflect the after-tax effect of a writedown of an investment in preferred stock of USAir Group, Inc. by $5,850,000, described in the section Convertible Preferred Stockholdings below. Earnings for 1993 include securities gains of $1,156,000, after income taxes.

Convertible Preferred Stockholdings

At the end of 1994, Wesco and its subsidiaries owned $135 million, at original cost, in convertible preferred stocks, all requiring redemption at par value within ten years or so from date of acquisition.

The investments are carried on Wesco's consolidated balance sheet at fair market value and, with the exception of the investment in preferred stock of USAir Group, Inc. ("USAir"), any differences between historical cost and market value are included in shareholders' equity, net of income tax effect, without affecting reported net income, according to accounting convention. The investment in USAir, however, was written down to fair market value effective at 1994 yearend, and the resulting $5.9 million after-tax loss on the writedown, is shown as a separate charge on Wesco's accompanying 1994 statement of income. Following is a summary of these investments:

Security	Preferred Dividend Rate	Par Value of Holding	Conversion Price at Which Par Value May Be Exchanged for Common Stock	Market Price of Common Stock on 12/31/94	12/31/94 Yearend Carrying Value of Holding
Salomon Inc	9.00%	$100 Million	$38.00	$37.50	$ 105 Million
USAir Group, Inc.	9.25%	12 Million	38.74	4.25	3 Million
Champion International Corporation	9.25%	23 Million	38.00	36.50	24.2 Million

These preferred stocks were purchased at the same time Wesco's parent corporation, Berkshire Hathaway, purchased additional amounts of the same stocks at the same price per share.

In previous years we noted that "few, if any, investors have ever prospered mightily from investing in convertible preferred stocks of leading corporations." Our three holdings at yearend 1994 appear to bear this out. We estimate that (1) our $100 million Salomon holding was worth about 5% more than we paid for it, and (2) our $23 million Champion holding was worth about 5% more than we paid for it. These figures when combined created $6.2 million in pre-tax *appreciation*, versus the $9 million pre-tax *loss* just recorded on our investment in USAir. Readers should bear in mind, however, that Wesco's experience to date has been good in an investment in convertible preferred stock of The Gillette Company, made in 1989 at cost of $40 million, and converted into Gillette common stock in 1991. This investment is

carried at a $119.8 million yearend market value in Wesco's consolidated 1994 balance sheet, $79.8 million higher than the investment cost. However, even with the good Gillette experience factored in, our overall investment returns from convertible preferred stockholdings have been unexciting, just as we have predicted.

New America Electrical Corporation ("New America Electric")

It was not just Wesco's savings and loan privileges that left our corporate fold in 1993. New America Electric, of which Wesco has owned about 80% since 1988, sold its business in 1993 to a long-established and high-quality Midwestern firm engaged in similar businesses. During 1993, Wesco's share of net loss was $192,000 for the six-month period preceding sale of the business, and Wesco realized an additional after-tax loss of $1.6 million ($.23 per Wesco share) on final disposition of its interest.

The sale decision was made entirely by Glen Mitchel, New America Electric's CEO and 20% owner, who did not wish to wait for an eventual upturn in commercial construction after years of enduring a worst-since-the-1930s business climate to which he had adjusted through several painful downsizings. The bad timing of Wesco in entering the electrical equipment field when it did was entirely the result of misjudgment by the writer, caused by a strong, near-lifelong preference for predicting relative consequences from business and human quality while not attempting to predict business cycles.

Considering the very hostile business climate we later encountered, New America Electric's business was always run extremely well by Glen Mitchel, and his dedication and skill prevented us from losing much more than we did. The writer caused Wesco's loss, not Glen Mitchel.

The foregoing comments were repeated verbatim from Wesco's 1993 report. The writer, as a minority selling shareholder of New America Electric, realized his pro rata share of profit made by all selling shareholders when Wesco bought 80% of New America Electric in 1988 in a transaction approved by Warren Buffett, Berkshire Hathaway's chairman, and non-Munger directors of Wesco, none of whom owned any shares in New America Electric. Under these circumstances, it is only fitting that the writer's nose be again publicly rubbed in the ensuing bad result for Wesco.

Consolidated Balance Sheet And Related Discussion

As indicated in the accompanying financial statements, Wesco increased its net worth, as accountants compute it under their conventions, to $678.1 million at yearend 1994, or about $95 per Wesco share, from $626.1 million at yearend 1993.

The $52 million increase in reported net worth in 1994 was the result of three factors: (1) $36.5 million resulting from continued net appreciation of investments after provision for future taxes on capital gains; (2) $12.0 million from retention of 1994 net income after deduction of dividends paid; (3) $3.5 million resulting from our decision at the beginning of 1994 to conform our accounting for investments in

securities with fixed maturities to our accounting for marketable equity securities, with the result that we now carry them on the consolidated balance sheet at market value.

The foregoing \$95-per-share book value approximates liquidation value assuming that all Wesco's non-security assets would liquidate, after taxes, at book value. Probably, this assumption is too conservative. But our computation of liquidation value is unlikely to be too low by more than a couple of dollars per Wesco share, because (1) the liquidation value of Wesco's consolidated real estate holdings (where interesting potential now lies almost entirely in Wesco's equity in its office property in Pasadena) is now far below its former high, and (2) unrealized appreciation in other assets (primarily Precision Steel) cannot be large enough, in relation to Wesco's overall size, to change very much the overall computation of after-tax liquidating value.

Of course, so long as Wesco does not liquidate, and does not sell any appreciated assets, it has, in effect, an interest-free "loan" from the government equal to its deferred income taxes on unrealized gains, subtracted in determining its net worth. This interest-free "loan" from the government is at this moment working for Wesco shareholders and amounted to about \$27 per Wesco share at yearend 1994.

However, some day, perhaps soon, major parts of the interest-free "loan" must be paid as assets are sold. Therefore, Wesco's shareholders have no perpetual advantage creating value for them of \$27 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than \$27 per Wesco share. In the writer's judgment, the value of Wesco's advantage from its temporary, interest-free "loan" was probably about \$9 per Wesco share at yearend 1994.

After the value of the advantage inhering in the interest-free "loan" is estimated, a reasonable approximation can be made of Wesco's intrinsic value per share. This approximation is made by simply adding (1) the value of the advantage from the interest-free "loan" per Wesco share and (2) liquidating value per Wesco share. Others may think differently, but the foregoing approach seems reasonable to the writer as a way of estimating intrinsic value per Wesco share.

Thus, if the value of the advantage from the interest-free tax-deferral "loan" present was \$9 per Wesco share at yearend 1994, and after-tax liquidating value was then about \$95 per share (figures that seem plenty high to the writer), Wesco's intrinsic value per share would become only about \$104 per share at yearend 1994, up 4% from intrinsic value as guessed in a similar calculation at the end of 1993.

And, finally, this reasonable-to-this-writer, \$104-per-share figure for intrinsic per share value of Wesco stock should be compared with the \$115.12 per share price at which Wesco stock was selling on December 31, 1994. This comparison indicates that Wesco stock was then selling about 11% above intrinsic value.

Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. In this connection, it should be noted that the writer caused or helped cause not only Wesco's New America Electric loss but also (1) what will now plainly turn out to be a bad financial result, opportunity cost considered, from development of foreclosed mostly-seaside land in the Montecito district of Santa Barbara and (2) some recent losses from boom-time mortgage loans on residences. Wesco, under the writer's leadership, has managed to be clobbered in three different ways by the California real estate crash, albeit in categories employing a very small portion of Wesco's assets.

Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway.

All that said, we make no attempt to appraise relative attractiveness for investment of Wesco versus Berkshire Hathaway stock at present stock-market quotations.

On January 18, 1995 Wesco increased its regular dividend from 24½ cents per share to 25½ cents per share, payable March 8, 1995, to shareholders of record as of the close of business on February 8, 1995.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Charles T. Munger
Chairman of the Board

March 9, 1995

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WESCO FINANCIAL CORPORATION

Annual Report 1995

Form 10-K Annual Report 1995

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" net operating income (i.e., before irregularly occurring items shown in the table below) for the calendar year 1995 increased to $30,208,000 ($4.24 per share) from $24,659,000 ($3.46 per share) in the previous year.

Consolidated net income (i.e., after irregularly occurring items shown in the table below) increased to $34,541,000 ($4.85 per share) from $18,972,000 ($2.66 per share) in the previous year.

Wesco has two major subsidiaries: Wesco-Financial Insurance Company ("Wes-FIC"), headquartered in Omaha and engaged principally in the reinsurance business, and Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended			
	December 31, 1995		December 31, 1994	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income of:				
Wesco-Financial Insurance business	$26,496	$3.72	$21,582	$3.03
Precision Steel businesses	2,386	.33	2,900	.40
All other "normal" net operating income[2]	1,326	.19	177	.03
	30,208	4.24	24,659	3.46
Net gain on sales of marketable securities	4,333	.61	163	.02
Decline in value of USAir preferred stock	—	—	(5,850)[3]	(.82)
Wesco consolidated net income	$34,541	$4.85	$18,972	$2.66

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses and costs and expenses associated with delinquent loans and foreclosed real estate previously charged against Wesco's former Mutual Savings and Loan Association subsidiary. Income was from ownership of the Wesco headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the insurance subsidiary.

(3) Represents writedown of investment in preferred stock of USAir Group, Inc., explained in section "Convertible Preferred Stockholdings" below.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

Wesco-Financial Insurance Company ("Wes-FIC")

Wes-FIC's normal net income for 1995 was $26,496,000, versus $21,582,000 for 1994. The profitability to date on its super-catastrophe ("super-cat") reinsurance business, which it entered in 1994, was responsible for this increase.

At the end of 1995 Wes-FIC retained about $33 million in invested assets, offset by claims reserves, from its former reinsurance arrangement with Fireman's Fund Group. This arrangement was terminated August 31, 1989. However, it will take a long time before all claims are settled, and, meanwhile, Wes-FIC is being helped over many years by proceeds from investing "float."

We previously informed shareholders that Wes-FIC had entered into the business of super-cat reinsurance through retrocessions from National Indemnity Company ("NICO"), a wholly owned insurance company subsidiary of Berkshire Hathaway, Wesco's ultimate parent. Wes-FIC's entry into the super-cat reinsurance business early in 1994 followed the large augmentation of its claims-paying capacity caused by its merger with Mutual Savings, the former savings and loan subsidiary of Wesco. In 1994, in recognition of Wes-FIC's sound financial condition, Standard and Poor's Corporation assigned to Wes-FIC the highest possible claims-paying-ability rating: AAA.

The super-cat reinsurance business, in which Wes-FIC is engaged, continues to be a very logical business for Wes-FIC. After all, Wes-FIC has a large net worth in relation to annual premiums being earned. And this is exactly the condition rationally required for any insurance company planning to be a "stand alone" reinsurer covering super-catastrophe risks it can't safely pass on to others sure to remain solvent if a large super-catastrophe comes. Such a "stand alone" reinsurer must be a kind of Fort Knox, prepared occasionally, without calling on any other reinsurers for help, to pay out in a single year many times more than premiums coming in, as it covers losses from some super catastrophe worse than Hurricane Andrew. In short, it needs a balance sheet a lot like Wes-FIC's.

In connection with the retrocessions of super-cat reinsurance from NICO to Wes-FIC the nature of the situation as it has evolved is such that Berkshire Hathaway, owning 100% of NICO and only 80% of Wesco and Wes-FIC, does not, for some philanthropic reason, ordinarily retrocede to Wes-FIC any reinsurance business that Berkshire Hathaway considers desirable and that is available only in amounts below what Berkshire Hathaway wants for itself on the terms offered. Instead, retrocessions occur only occasionally, under limited conditions and with some compensation to Berkshire Hathaway. Such retrocessions ordinarily happen only (1) when Berkshire Hathaway, for some reason (usually a policy of overall risk limitation), desires lower amounts of business than are available on the terms offered and (2) Wes-FIC has adequate capacity to bear the risk assumed and (3) Wes-FIC pays a fair ceding commission designed to cover part of the cost of getting and managing insurance business.

Generally, Berkshire Hathaway, in dealing with partly owned subsidiaries, tries to lean over a little backward in an attempt to observe what Justice Cardozo called "the punctilio of an honor the most sensitive," but it cannot be expected to make large and plain giveaways of Berkshire Hathaway assets or business to a partially owned subsidiary like Wes-FIC.

Given Berkshire Hathaway's unwillingness to make plain giveaways to Wes-FIC and reductions in opportunities in the super-cat reinsurance market in recent years, prospects are often poor for Wes-FIC's acquisition of retroceded super-cat reinsurance. Nonetheless, in February 1994, Wes-FIC was offered by NICO participations in four very unusual super-cat reinsurance contracts. Considering its other exposures to the same risks, NICO was willing to retrocede to Wes-FIC 20% of what was then available to NICO under each contract in return for a ceding commission amounting to 3% of Wes-FIC's premiums to be received. The remaining 80% of the risk was to be retained by NICO. A little later, a fifth retrocession was offered: 10% of a one-year NICO property loss contract with a maximum loss amount of $50 million. The annual premium was 5% of the maximum possible loss. Then, in June, a sixth contract became available.

Wes-FIC promptly accepted all of these six unusual super-cat reinsurance participations offered by NICO in 1994.

In the first four contracts, in aggregate, Wes-FIC thus became exposed, during a single year, to either winning about $4 million pre-tax or losing about $20 million pre-tax. In addition, there is some slight possibility of a huge "long tail" loss for Wes-FIC and NICO many years after the four contracts ended, because a minority part of the insurance was liability insurance written on an "occurrence" basis. This is not the first time such "long tail" risks have been accepted by Wes-FIC. There are also, it should be remembered, possibilities for unpleasant surprises involving similar possible large "long tail" losses, many years hence, from Wes-FIC's long-terminated reinsurance arrangement with Fireman's Fund Group. Wes-FIC, now as then, is willing to run such "long tail" risks, carefully weighed against prospects for gain, provided it is much better capitalized than other insurance companies more influenced by animal spirits and institutional momentums.

In the fifth super-cat retrocession to Wes-FIC from NICO, which covered only property loss, there was no possibility of a surprising "long tail" loss. However, for the year covered, Wes-FIC had a very small chance of losing $5 million pre-tax, while it could gain only $250,000, less 3%, leaving Wes-FIC's net proceeds $242,500, pre-tax.

In the sixth retrocession from NICO, Wes-FIC participated to the extent of 5% in a $400 million contract with 20th Century Industries, a California insurer currently attempting to recover from devastating effects of the Northridge, California earthquake. The amount of reinsurance under the contract (covering what was mostly earthquake risk) declined monthly over the term, and expired early in 1995 as 20th Century withdrew from the homeowners and earthquake insurance markets in California. Wes-FIC earned a premium of approximately $1 million in 1995 under the contract.

Needless to say, NICO does not believe that the average yearly loss to be expected from writing over many years a great series of super-cat reinsurance contracts like those it has retroceded in part to Wes-FIC would be as high as the one-year premiums to be received. But such super-cat reinsurance, like other super-cat reinsurance, is not for the faint of heart. A huge variation in annual results, with some very unpleasant years, is inevitable.

But it is precisely what must, in the nature of things, be associated with these bad possibilities, with their huge and embarrassing adverse consequences in occasional years, that makes Wes-FIC like its way of being in the super-cat business. Buyers (particularly wise buyers) of super-cat reinsurance often want to deal with wholly owned Berkshire Hathaway subsidiaries (possessing as they do the highest possible credit ratings and a reliable corporate personality) instead of other reinsurers less cautious, straightforward and well endowed. And many competing sellers of super-cat reinsurance are looking for a liberal "intermediary's" profit, hard to get because they must find a "layoff" reinsurer both (1) so smart that it is sure to stay strong enough to pay possible losses yet (2) so casual about costs that it is not much bothered by a liberal profit earned by some intermediary entity not willing to retain any major risk. Thus the forces in place can rationally be expected to cause acceptable long-term results for well-financed, disciplined decision makers, despite horrible losses in some years and other years of restricted opportunity to write business. And, again, we wish to repeat that we expect only acceptable long-term results. We see no possibility for bonanza.

It should also be noted that Wes-FIC, in the arrangements recently made with NICO, receives a special business-acquisition advantage from using Berkshire Hathaway's general reputation. Under all the circumstances, a 3% ceding commission seems more than fair to Wes-FIC. Certainly and obviously, Berkshire Hathaway would not offer terms so good to any other entity outside the Berkshire Hathaway affiliated group.

Finally, we repeat an important disclosure about Wes-FIC's super-cat-reinsurance-acquisition mechanics. It is impractical to have people in California make complex accept-or-reject decisions for Wes-FIC when retrocessions of reinsurance are offered by Berkshire Hathaway insurance subsidiaries. But, happily, the Berkshire Hathaway insurance group executives making original business-acquisition decisions are greatly admired and trusted by the writer and will be "eating their own cooking." Under such circumstances, Wesco's and Wes-FIC's boards of directors, on the writer's recommendation, have simply approved automatic retrocessions of reinsurance to Wes-FIC as offered by one or more wholly owned Berkshire Hathaway subsidiaries. Each retrocession is to be accepted forthwith in writing in Nebraska by agents of Wes-FIC who are at the same time salaried employees of wholly owned subsidiaries of Berkshire Hathaway. Moreover, each retrocession will be made at a 3%-of-premiums ceding commission. Finally, two conditions must be satisfied: (1) Wes-FIC must get 20% or less of the risk (before taking into account effects from the ceding commission) and (2) wholly owned Berkshire Hathaway subsidiaries must retain at least 80% of the identical risk (again, without taking into account effects from the ceding commission).

We will not ordinarily describe individual super-cat reinsurance contracts in full detail to Wesco shareholders. That would be contrary to our competitive interest. Instead, we will try to summarize reasonably, more or less as we have done here.

Will more reinsurance be later available to Wes-FIC through Berkshire Hathaway subsidiaries on the basis and using the automatic procedure we have above described? Well, we have often proved poor prognosticators. We can only say that we hope so and that more reinsurance should come, albeit irregularly and with long intermissions, if buyers of super-cat coverage are rational. However, in 1995 no entirely new super-cat contracts were retroceded to Wes-FIC.

We continue to examine other possible insurance-writing opportunities, and also insurance company acquisitions, not involving Berkshire Hathaway.

Wes-FIC is now a very strong insurance company, with very low costs, and, one way or another, in the future as in the past, we expect to continue to find and seize at least a few sensible insurance opportunities.

On super-cat reinsurance accepted by Wes-FIC to date (March 8, 1996) there has been no loss whatsoever that we know of. Underwriting profit of $6.3 million, before taxes, benefited 1995 earnings. In contrast, no underwriting profit flowed through Wesco's books in 1994 because none of its super-cat contracts expired in 1994, and our accounting policy requires contract expiration before super-cat underwriting profit is recognized. Needless to say, we would not have similar reluctance to report losses before contract expirations. Our super-cat accounting policy is not irrationally super-conservative, although it may amount to "best-practice" accounting.

Precision Steel

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, contributed $2,386,000 to normal net operating income in 1995, down 18% compared with $2,900,000 in 1994. The decrease in 1995 profit occurred as pounds of product sold decreased 9%. Revenues were up only 0.2%, reflecting the pounding which competition gave to prices.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1995 continued to provide an excellent return on resources employed.

Tag Ends from Savings and Loan Days

All that now remains outside Wes-FIC but within Wesco as a consequence of Wesco's former involvement with Mutual Savings, Wesco's long-held savings and loan subsidiary, is a small real estate subsidiary, MS Property Company, that holds tag ends of assets and liabilities with a net book value (after writedowns considered adequate) of about $25 million. Operations (including writedowns) of MS Property Company caused an after-tax loss to Wesco in 1995 of about $700,000. Sooner or later Wesco is expected to realize at least a little more than $25 million from MS Property Company's net assets, after earning modest returns until that time on the $25 million of book value involved. MS Property Company's 1995 loss, immaterial versus Wesco's present size, is included in the foregoing breakdown of earnings within "all other 'normal' net operating income."

Of course, the main tag end from Wesco's savings and loan days is 7,200,000 shares of Federal Home Loan Mortgage Corporation ("Freddie Mac"), purchased by Mutual Savings for $71.7 million at a time when Freddie Mac shares could be lawfully owned only by a savings and loan association. This holding, with a market value of $601.2 million at yearend 1995, now reposes in Wes-FIC. And, in the years following our initial purchase, Freddie Mac and its similar cousin, "Fannie Mae," have made matters pretty miserable for the savings and loan industry by taking over most financing of low-to-moderate-cost homes.

For us, at least, our experience in shifting from savings and loan operation to ownership of Freddie Mac shares tends to confirm a long-held notion that being prepared, on a few occasions in a lifetime, to act promptly in scale in doing some simple thing will often be enough to make the financial results of that lifetime quite satisfactory.

All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, increased to $1,326,000 in 1995 from $177,000 in 1994. Sources were (1) rents ($2,954,000 gross) from Wesco's Pasadena office property (leased almost entirely to outsiders and with CenFed Bank as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiary, mostly offset in both years by costs and expenses (including additions to loss reserves) of liquidating tag-end delinquent loans and foreclosed real estate. The 1995 and 1994 figures also include intercompany charges for interest expense ($965,000 and $826,000 after taxes, respectively) on borrowings from Wes-FIC principally made late in 1993 to facilitate the transfer of loans and foreclosed properties to MS Property Company. This intercompany interest expense does not affect Wesco's consolidated net income inasmuch as the same amount is included as interest income in Wes-FIC's "normal" net operating income.

Net Securities Gains and Losses

Wesco's aggregate net gains on sales of securities, combined, amounted to $4,333,000, after income taxes, in 1995, and included $4,192,000 realized on the conversion to common stock and sale of Wesco's investment in cumulative convertible preferred stock of Champion International Corporation. Wesco's earnings for 1994 contained securities gains of $163,000, after income taxes, and also reflected the after-tax effect of a writedown of an investment in preferred stock of USAir Group, Inc. by $5,850,000, described in the following section entitled "Convertible Preferred Stockholdings."

Convertible Preferred Stockholdings

At the end of 1995, Wesco and its subsidiaries owned $92 million, at original cost, in convertible preferred stocks of Salomon Inc ("Salomon") and USAir Group, Inc. ("USAir"), both requiring redemption at par value within ten years or so from date of acquisition.

The investments are carried on Wesco's consolidated balance sheet at fair market value, with any difference between historical cost and market value as to Salomon, and between adjusted cost and market value as to USAir, included in shareholders' equity, net of income tax effect, without affecting reported net income, according to accounting convention. The investment in USAir was written down to fair market value of $3 million effective December 31, 1994, and this $3 million figure is now treated as adjusted cost; the $5.9 million after-tax loss on the writedown to the new adjusted cost was shown as a separate charge on Wesco's 1994 statement of income. Following is a summary of these investments at yearend 1995:

Security	Preferred Dividend Rate	Par Value of Holding	Conversion Price at which Par Value may be Exchanged for Common Stock	Market Price of Common Stock on 12/31/95	12/31/95 Yearend Carrying Value of Holding
Salomon Inc.	9.00%	$80 Million	$38.00	$35.38	$ 84 Million
USAir Group, Inc.	9.25%	12 Million	38.74	13.25	7.2 Million

These preferred stocks were purchased at the same time Wesco's parent corporation, Berkshire Hathaway, purchased additional amounts of the same stocks at the same price per share. On October 31, 1995, in accordance with the terms of its convertible preferred stock, Salomon redeemed $20 million par value of its shares owned by Wesco at cost plus accrued dividends.

In previous years we noted that "few, if any, investors have ever prospered mightily from investing in convertible preferred stocks of leading corporations." Our two holdings at yearend 1995 appear to bear this out. We estimate that (1) our $80 million Salomon holding was worth about $4 million more than we paid for it, and (2) our $12 million USAir holding, written down to an adjusted cost of $3 million at yearend 1994, was worth about $4.2 million more than such adjusted cost, but $4.8 million less than we paid for it. These figures when combined created $8.2 million in pre-tax appreciation above adjusted cost, and $0.8 million less than actual cost, considering the $9 million pre-tax loss realized in 1994 on the USAir Group writedown. Readers should bear in mind, however, that Wesco's experience to date has been much better in an investment in convertible preferred stock of The Gillette Company, made in 1989 at cost of $40 million, and converted into Gillette common stock in 1991. This investment is carried at a $166.8 million yearend market value in Wesco's consolidated 1995 balance sheet, $126.8 million higher than the investment cost. Also, as discussed above, Wesco realized an after-tax gain of $4.2 million in 1995 on the conversion to common stock and sale of its $23 million investment in preferred stock of Champion International Corporation. However, even with all good experience factored in, our overall investment returns from convertible preferred stockholdings have been unexciting, just as we have predicted.

Consolidated Balance Sheet And Related Discussion

As indicated in the accompanying financial statements, Wesco increased its net worth, as accountants compute it under their conventions, to $957.6 million ($134

per Wesco share) at yearend 1995 from $678.1 million ($95 per Wesco share) at yearend 1994.

The $279.5 million increase in reported net worth in 1995 was the result of two factors: (1) $252.2 million resulting from continued net appreciation of investments after provision for future taxes on capital gains; and (2) $27.3 million from retention of 1995 net income after deduction of dividends paid.

The foregoing $134-per-share book value approximates liquidation value assuming that all Wesco's non-security assets would liquidate, after taxes, at book value. Probably, this assumption is too conservative. But our computation of liquidation value is unlikely to be too low by more than a couple of dollars per Wesco share, because (1) the liquidation value of Wesco's consolidated real estate holdings (where interesting potential now lies almost entirely in Wesco's equity in its office property in Pasadena) is now far below its former high, and (2) unrealized appreciation in other assets (primarily Precision Steel) cannot be large enough, in relation to Wesco's overall size, to change very much the overall computation of after-tax liquidating value.

Of course, so long as Wesco does not liquidate, and does not sell any appreciated assets, it has, in effect, an interest-free "loan" from the government equal to its deferred income taxes on unrealized gains, subtracted in determining its net worth. This interest-free "loan" from the government is at this moment working for Wesco shareholders and amounted to about $45 per Wesco share at yearend 1995.

However, some day, perhaps soon, major parts of the interest-free "loan" must be paid as assets are sold. Therefore, Wesco's shareholders have no perpetual advantage creating value for them of $45 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than $45 per Wesco share. In the writer's judgment, the value of Wesco's advantage from its temporary, interest-free "loan" was probably about $15 per Wesco share at yearend 1995.

After the value of the advantage inhering in the interest-free "loan" is estimated, a reasonable approximation can be made of Wesco's intrinsic value per share. This approximation is made by simply adding (1) the value of the advantage from the interest-free "loan" per Wesco share and (2) liquidating value per Wesco share. Others may think differently, but the foregoing approach seems reasonable to the writer as a way of estimating intrinsic value per Wesco share.

Thus, if the value of the advantage from the interest-free tax-deferral "loan" present was $15 per Wesco share at yearend 1995, and after-tax liquidating value was then about $134 per share (figures that seem rational to the writer), Wesco's intrinsic value per share would become only about $149 per share at yearend 1995, up 43% from intrinsic value as guessed in a similar calculation at the end of 1994. And, finally, this reasonable-to-this-writer, $149-per-share figure for intrinsic per share value of Wesco stock should be compared with the $182 per share price at

which Wesco stock was selling on December 31, 1995. This comparison indicates that Wesco stock was then selling about 22% above intrinsic value.

Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. In this connection, it should be remembered that the writer caused or helped cause (1) a loss on Wesco's former electrical equipment subsidiary, (2) what will now plainly turn out to be a bad financial result from development of foreclosed mostly-seaside land in the Montecito district of Santa Barbara and (3) some recent losses from boom-time mortgage loans on residences. Wesco, under the writer's leadership, managed to be clobbered in three different ways by the California real estate crash, albeit in categories employing a very small portion of Wesco's assets.

Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway.

All that said, we make no attempt to appraise relative attractiveness for investment of Wesco versus Berkshire Hathaway stock at present stock-market quotations.

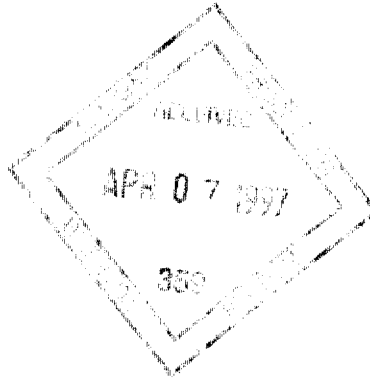
We are not now pessimists, on a long-term basis, about business expansion. Despite present ebullient markets for entire businesses, making it hard for Wesco to find attractive opportunities, we do not believe that such opportunities will never come.

On January 17, 1996 Wesco increased its regular dividend from 25½ cents per share to 26½ cents per share, payable March 6, 1996, to shareholders of record as of the close of business on February 7, 1996.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Charles T. Munger
Chairman of the Board

March 8, 1996



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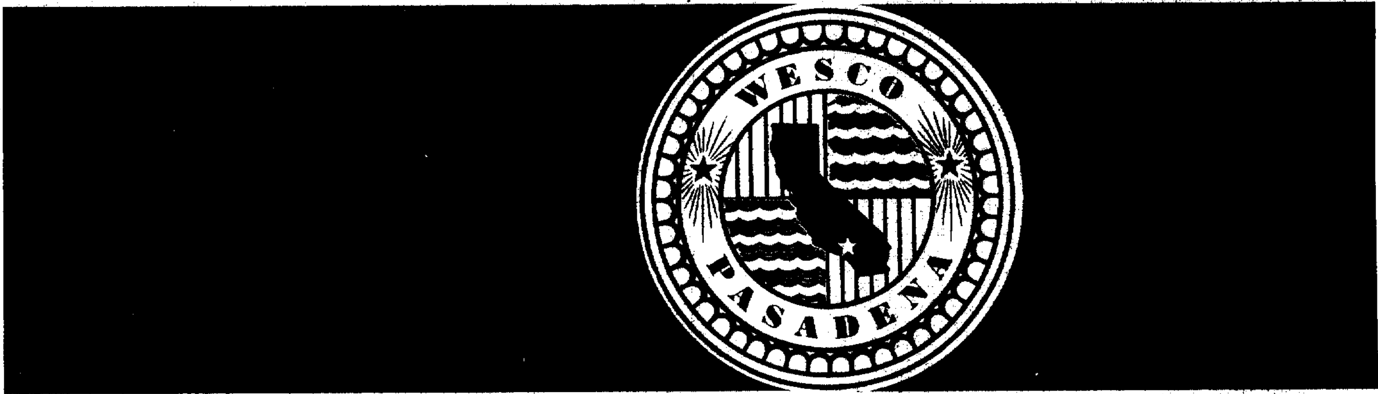


WESCO FINANCIAL CORPORATION

Annual Report 1996

Form 10-K Annual Report 1996

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" net operating income (i.e., before irregularly occurring items shown in the table below) for the calendar year 1996 increased to $30,734,000 ($4.32 per share) from $30,208,000 ($4.24 per share) in the previous year.

Consolidated net income (i.e., after irregularly occurring items shown in the table below) decreased to $30,619,000 ($4.30 per share) from $34,541,000 ($4.85 per share) in the previous year.

Wesco has three major subsidiaries: (1) Wesco-Financial Insurance Company ("Wes-FIC"), headquartered in Omaha and engaged principally in the reinsurance business, (2) The Kansas Bankers Surety Company ("KBS"), purchased by Wes-FIC in July 1996 and specializing in insurance products tailored to midwestern banks, and (3) Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended			
	December 31, 1996		December 31, 1995	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income of:				
Wes-FIC and KBS insurance businesses	$27,249	$3.83	$26,496	$3.72
Precision Steel businesses	3,033	.43	2,386	.33
All other "normal" net operating income[2]	452	.06	1,326	.19
	30,734	4.32	30,208	4.24
Net gain (loss) on sales of marketable securities	(115)	(.02)	4,333	.61
Wesco consolidated net income	$30,619	$4.30	$34,541	$4.85

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses, and costs and expenses associated with delinquent loans and foreclosed real estate previously charged against Wesco's former Mutual Savings and Loan Association subsidiary. Income was from ownership of the Wesco headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the insurance subsidiaries.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

Wesco-Financial Insurance Company ("Wes-FIC")

Wes-FIC's normal net income for 1996 was $27,249,000, versus $26,496,000 for 1995. The 1996 figure includes $2,288,000 contributed by The Kansas Bankers Surety Company ("KBS") following its purchase by Wes-FIC early in the third

quarter. The purchase of KBS is discussed in the section, "The Kansas Bankers Surety Company," below.

At the end of 1996 Wes-FIC retained about $31 million in invested assets, offset by claims reserves, from its former reinsurance arrangement with Fireman's Fund Group. This arrangement was terminated August 31, 1989. However, it will take a long time before all claims are settled, and, meanwhile, Wes-FIC is being helped over many years by proceeds from investing "float."

We previously informed shareholders that Wes-FIC had entered into the business of super-cat reinsurance through retrocessions from the Insurance Group of Berkshire Hathaway, Wesco's ultimate parent. Wes-FIC's entry into the super-cat reinsurance business early in 1994 followed the large augmentation of its claims-paying capacity caused by its merger with Mutual Savings, the former savings and loan subsidiary of Wesco. In 1994, in recognition of Wes-FIC's sound financial condition, Standard and Poor's Corporation assigned to Wes-FIC the highest possible claims-paying-ability rating: AAA.

The super-cat reinsurance business, in which Wes-FIC is engaged, continues to be a very logical business for Wes-FIC. Wes-FIC has a large net worth in relation to annual premiums being earned. And this is exactly the condition rationally required for any insurance company planning to be a "stand alone" reinsurer covering super-catastrophe risks it can't safely pass on to others sure to remain solvent if a large super-catastrophe comes. Such a "stand alone" reinsurer must be a kind of Fort Knox, prepared occasionally, without calling on any other reinsurers for help, to pay out in a single year many times more than premiums coming in, as it covers losses from some super catastrophe worse than Hurricane Andrew. In short, it needs a balance sheet a lot like Wes-FIC's.

In connection with the retrocessions of super-cat reinsurance to Wes-FIC from the Berkshire Hathaway Insurance Group, the nature of the situation as it has evolved is such that Berkshire Hathaway, owning 100% of its Insurance Group and only 80% of Wesco and Wes-FIC, does not, for some philanthropic reason, ordinarily retrocede to Wes-FIC any reinsurance business that Berkshire Hathaway considers desirable and that is available only in amounts below what Berkshire Hathaway wants for itself on the terms offered. Instead, retrocessions occur only occasionally, under limited conditions and with some compensation to Berkshire Hathaway. Such retrocessions ordinarily happen only (1) when Berkshire Hathaway, for some reason (usually a policy of overall risk limitation), desires lower amounts of business than are available on the terms offered and (2) Wes-FIC has adequate capacity to bear the risk assumed and (3) Wes-FIC pays a fair ceding commission designed to cover part of the cost of getting and managing insurance business.

Generally, Berkshire Hathaway, in dealing with partly owned subsidiaries, tries to lean over a little backward in an attempt to observe what Justice Cardozo called "the punctilio of an honor the most sensitive," but it cannot be expected to make large and plain giveaways of Berkshire Hathaway assets or business to a partially owned subsidiary like Wes-FIC.

Given Berkshire Hathaway's unwillingness to make plain giveaways to Wes-FIC and reductions in opportunities in the super-cat reinsurance market in recent years, prospects are often poor for Wes-FIC's acquisition of retroceded super-cat reinsurance.

Moreover, Wesco shareholders should continue to realize that super-cat reinsurance is not for the faint of heart. A huge variation in annual results, with some very unpleasant future years for Wes-FIC, is inevitable.

But it is precisely what must, in the nature of things, be associated with these bad possibilities, with their huge and embarrassing adverse consequences in occasional years, that makes Wes-FIC like its way of being in the super-cat business. Buyers (particularly wise buyers) of super-cat reinsurance often want to deal with Berkshire Hathaway subsidiaries (possessing as they do the highest possible credit ratings and a reliable corporate personality) instead of other reinsurers less cautious, straightforward and well endowed. And many competing sellers of super-cat reinsurance are looking for a liberal "intermediary's" profit, hard to get because they must find a "layoff" reinsurer both (1) so smart that it is sure to stay strong enough to pay possible losses yet (2) so casual about costs that it is not much bothered by a liberal profit earned by some intermediary entity not willing to retain any major risk. Thus the forces in place can rationally be expected to cause acceptable long-term results for well-financed, disciplined decision makers, despite horrible losses in some years and other years of restricted opportunity to write business. And, again, we wish to repeat that we expect only acceptable long-term results. We see no possibility for bonanza.

It should also be noted that Wes-FIC, in the arrangements with the Insurance Group of Berkshire Hathaway, receives a special business-acquisition advantage from using Berkshire Hathaway's general reputation. Under all the circumstances, the 3% ceding commission now being paid seems more than fair to Wes-FIC. Certainly and obviously, Berkshire Hathaway would not offer terms so good to any other entity outside the Berkshire Hathaway affiliated group.

Finally, we repeat an important disclosure about Wes-FIC's super-cat-reinsurance-acquisition mechanics. It is impractical to have people in California make complex accept-or-reject decisions for Wes-FIC when retrocessions of reinsurance are offered by the Berkshire Hathaway Insurance Group. But, happily, the Berkshire Hathaway Insurance Group executives making original business-acquisition decisions are greatly admired and trusted by the writer and will be "eating their own cooking." Under such circumstances, Wesco's and Wes-FIC's boards of directors, on the writer's recommendation, have simply approved automatic retrocessions of reinsurance to Wes-FIC as offered by one or more wholly owned Berkshire Hathaway subsidiaries. Each retrocession is to be accepted forthwith in writing in Nebraska by agents of Wes-FIC who are at the same time salaried employees of wholly owned subsidiaries of Berkshire Hathaway. Moreover, each retrocession will be made at a 3%-of-premiums ceding commission. Finally, two conditions must be satisfied: (1) Wes-FIC must get 20% or less of the risk (before taking into account

effects from the ceding commission) and (2) wholly owned Berkshire Hathaway subsidiaries must retain at least 80% of the identical risk (again, without taking into account effects from the ceding commission).

We will not ordinarily describe individual super-cat reinsurance contracts in full detail to Wesco shareholders. That would be contrary to our competitive interest. Instead, we will try to summarize reasonably any items of very large importance.

Will more reinsurance be later available to Wes-FIC through Berkshire Hathaway subsidiaries on the basis and using the automatic procedure we have above described? Well, we have often proved poor prognosticators. We can only say that we hope so and that more reinsurance should come, albeit irregularly and with long intermissions. However, only three new contracts became available and were taken on by Wes-FIC in 1996, with one of these not being a super-cat contract and another becoming effective starting in January 1997. Moreover, all Wes-FIC's super-cat policies written before 1996 had expired by yearend 1996.

We continue to examine other possible insurance-writing opportunities, and also insurance company acquisitions, like and unlike the purchase of our recently acquired KBS.

Wes-FIC is now a very strong insurance company, with very low costs, and, one way or another, in the future as in the past, we expect to continue to find and seize at least a few sensible insurance opportunities.

On super-cat reinsurance accepted by Wes-FIC to date (March 7, 1997) there has been no loss whatsoever that we know of. Underwriting profit of $3.9 million, before taxes, benefited 1996 earnings, versus $6.3 million in 1995. Our accounting policy requires contract expiration before super-cat underwriting profit is recognized. Needless to say, we would not have similar reluctance to report losses before contract expirations. Our super-cat accounting policy is not irrationally super-conservative, although it may amount to "best-practice" accounting.

The Kansas Bankers Surety Company ("KBS")

KBS, purchased by Wes-FIC early in the third quarter of 1996 for approximately $80 million in cash, contributed $2,288,000 to the normal net operating income of the insurance businesses, after adjustments under consolidated accounting convention. The results of KBS have been combined with those of Wes-FIC, and are included in the foregoing table in the category, "'normal' net operating income of Wes-FIC and KBS insurance businesses."

The acquisition of KBS became available to, and was accepted by, Wesco following an agreement entered into with KBS by Berkshire Hathaway, under which Berkshire agreed to acquire the stock of the surety company with the intention of having the transaction completed by Wesco or its insurance subsidiary. If you deduct the $63.9 million of cash, cash-equivalent investments, investments in obligations

backed by the Federal government and its agencies, and state and municipal bonds owned by KBS as of the purchase date, this left Wesco with approximately $16 million less in net investable assets after the acquisition. This reduction in investable assets was considered worth accepting, given the likely future underwriting profit of KBS.

KBS was chartered in 1909 to underwrite deposit insurance for Kansas banks. Its offices are in Topeka, Kansas. Over the years its service has continued to adapt to the changing needs of the banking industry. Today its customer base, consisting mostly of small and medium-sized community banks, is spread throughout 22 mainly midwestern states. In addition to bank deposit guaranty bonds which insure deposits in excess of FDIC coverage, KBS also offers directors and officers indemnity policies, bank employment practices policies, bank annuity and mutual funds indemnity policies and bank insurance agents professional errors and omissions indemnity policies.

KBS is run by Donald Towle, President, assisted by 13 dedicated officers and employees.

Precision Steel

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, contributed $3,033,000 to normal net operating income in 1996, up 27% compared with $2,386,000 in 1995. However, the substantial improvement in 1996 earnings was due mainly to LIFO inventory accounting adjustments, which increased after-tax earnings approximately $250,000 in 1996 after reducing such earnings by $460,000 in 1995. We do not regard earnings changes from LIFO accounting adjustments, up or down, as material in predicting future earning power. The increase in 1996 profit occurred as pounds of product sold increased 7%. Revenues were up only 2.2%.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1996 continued to provide an excellent return on resources employed.

Tag Ends from Savings and Loan Days

All that now remains outside Wes-FIC but within Wesco as a consequence of Wesco's former involvement with Mutual Savings, Wesco's long-held savings and loan subsidiary, is a small real estate subsidiary, MS Property Company, that holds tag ends of assets and liabilities with a net book value (after writedowns considered adequate) of about $24 million. Operations (including writedowns, of which there were none in 1996) of MS Property Company caused an after-tax loss to Wesco in 1996 of about $400,000. Sooner or later Wesco is expected to realize at least a little more than $24 million from MS Property Company's net assets, after earning modest returns until that time on the $24 million of book value involved. MS Property Company's 1996 loss, immaterial versus Wesco's present size, is included in the foregoing breakdown of earnings within "all other 'normal' net operating income."

It is anticipated that in 1997 Wesco will be able to make a substantial net withdrawal, in cash, from MS Property Company following sale of various real estate assets.

Of course, the main tag end from Wesco's savings and loan days is 28,800,000 shares (reflecting a 4-for-1 split distributed shortly after yearend 1996) of Federal Home Loan Mortgage Corporation ("Freddie Mac"), purchased by Mutual Savings for $71.7 million at a time when Freddie Mac shares could be lawfully owned only by a savings and loan association. This holding, with a market value of $794.7 million at yearend 1996, now reposes in Wes-FIC. And, in the years following our initial purchase, Freddie Mac and its similar cousin, "Fannie Mae," have made matters pretty miserable for the savings and loan industry by taking over most financing of low-to-moderate-cost homes.

Our experience in shifting from savings and loan operation to ownership of Freddie Mac shares tends to confirm a long-held notion that being prepared, on a few occasions in a lifetime, to act promptly in scale in doing some simple and logical thing will often dramatically improve the financial results of that lifetime. A few major opportunities, clearly recognizable as such, will usually come to one who continuously searches and waits, with a curious mind, loving diagnosis involving multiple variables. And then all that is required is a willingness to bet heavily when the odds are extremely favorable, using resources available as a result of prudence and patience in the past.

All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, decreased to $452,000 in 1996 from $1,326,000 in 1995. Sources were (1) rents ($2,917,000 gross) from Wesco's Pasadena office property (leased almost entirely to outsiders, including CenFed Bank as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiaries, mostly offset in both years by costs and expenses of liquidating tag-end delinquent loans and foreclosed real estate. The 1996 and 1995 figures also include intercompany charges for interest expense ($298,000 and $965,000 after taxes, respectively) on borrowings from Wes-FIC principally made late in 1993 to facilitate the transfer of loans and foreclosed properties to MS Property Company. This intercompany interest expense does not affect Wesco's consolidated net income inasmuch as the same amount is included as interest income in Wes-FIC's "normal" net operating income.

Net Securities Gains and Losses

Wesco's earnings for 1996 contained securities losses of $115,000, after income taxes, versus net gains of $4,333,000, after income taxes, in 1995. The latter figure included $4,192,000 realized on the conversion to common stock and sale of Wesco's investment in convertible preferred stock of Champion International Corporation.

Convertible Preferred Stockholdings

At the end of 1996, Wesco and its subsidiaries owned $72 million, at original cost, in convertible preferred stocks of Salomon Inc ("Salomon") and USAir Group, Inc. ("USAir"), both requiring redemption at par value or conversion to common stock within the next few years.

The investments are carried on Wesco's consolidated balance sheet at fair market value, with any difference between historical cost and market value as to Salomon, and between adjusted cost and market value as to USAir, included in shareholders' equity, net of income tax effect, without affecting reported net income, according to accounting convention. The investment in USAir was written down to a fair market value of $3 million effective December 31, 1994, and this $3 million figure is now treated as adjusted cost; the $5.9 million after-tax loss on the writedown to the new adjusted cost was shown as a separate charge on Wesco's 1994 statement of income. Following is a summary of these investments in convertible preferred stocks at yearend 1996:

Security	Preferred Dividend Rate	Par Value of Holding	Conversion Price at Which Par Value May Be Exchanged for Common Stock	Market Price of Common Stock on 12/31/96	12/31/96 Yearend Carrying Value of Holding
Salomon Inc.	9.00%	$60 Million	$38.00	$47.125	$ 66 Million
USAir Group, Inc.	9.25%	12 Million	38.74	23.375	10.8 Million

These convertible preferred stocks were purchased at the same time Wesco's parent corporation, Berkshire Hathaway, purchased additional amounts of the same stocks at the same price per share. On October 31, 1995, in accordance with the terms of its convertible preferred stock, Salomon redeemed $20 million par value of its preferred shares owned by Wesco at cost plus accrued dividends. One year later, on October 31, 1996, Wesco converted $20 million par value of its remaining preferred shares of Salomon to 526,314 shares of common stock of Salomon. Market value of these common shares, carried in the category "marketable equity securities" in Wesco's financial statements, was $24.8 million at yearend 1996.

In previous years we noted that "few, if any, investors have ever prospered mightily from investing in convertible preferred stocks of leading corporations." Our two holdings at yearend 1996 appear to bear this out. We estimate that (1) our $60 million Salomon holding was worth about $6 million more than we paid for it, and (2) our $12 million USAir holding, written down to an adjusted cost of $3 million at yearend 1994, was at yearend 1996 worth about $7.8 million more than such adjusted cost, but $1.2 million less than we paid for it. These figures when combined created $13.8 million in pre-tax appreciation above adjusted cost, and $4.8 million more than actual cost, considering the $9 million pre-tax loss shown in 1994 on the USAir Group writedown. Readers should bear in mind, however, that Wesco's experience to date has been very much better in an investment in convertible preferred stock of The Gillette Company, made in 1989 at cost of $40 million, and converted into Gillette common stock in 1991. This investment is carried at a $248.8 million yearend market value in Wesco's consolidated 1996

balance sheet. This is $200.8 million more than the investment cost. Also, as discussed above, Wesco realized an after-tax gain of $4.2 million in 1995 on sale of its $23 million investment in preferred stock of Champion International Corporation. However, even with all good experience factored in, our overall investment returns from convertible preferred stockholdings have been unexciting, although somewhat better than we predicted.

Consolidated Balance Sheet And Related Discussion

As indicated in the accompanying financial statements, Wesco increased its net worth, as accountants compute it under their conventions, to $1.25 billion ($176 per Wesco share) at yearend 1996 from $957 million ($134 per Wesco share) at yearend 1995.

The $293 million increase in reported net worth in 1996 was the result of two factors: (1) $270 million resulting from continued net appreciation of investments after provision for future taxes on capital gains; and (2) $23 million from retention of 1996 net income after deduction of dividends paid.

The foregoing $176-per-share book value approximates liquidation value assuming that all Wesco's non-security assets would liquidate, after taxes, at book value. Probably, this assumption is too conservative. But our computation of liquidation value is unlikely to be too low by more than a couple of dollars per Wesco share, because (1) the liquidation value of Wesco's consolidated real estate holdings (where interesting potential now lies almost entirely in Wesco's equity in its office property in Pasadena) is now far below its former high, and (2) unrealized appreciation in other assets (primarily Precision Steel) cannot be large enough, in relation to Wesco's overall size, to change very much the overall computation of after-tax liquidating value.

Of course, so long as Wesco does not liquidate, and does not sell any appreciated assets, it has, in effect, an interest-free "loan" from the government equal to its deferred income taxes on unrealized gains, subtracted in determining its net worth. This interest-free "loan" from the government is at this moment working for Wesco shareholders and amounted to about $66 per Wesco share at yearend 1996.

However, some day, perhaps soon, major parts of the interest-free "loan" must be paid as assets are sold. Therefore, Wesco's shareholders have no perpetual advantage creating value for them of $66 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than $66 per Wesco share. In the writer's judgment, the value of Wesco's advantage from its temporary, interest-free "loan" was probably about $20 per Wesco share at yearend 1996.

After the value of the advantage inhering in the interest-free "loan" is estimated, a reasonable approximation can be made of Wesco's intrinsic value per share. This approximation is made by simply adding (1) the value of the advantage from the interest-free "loan" per Wesco share and (2) liquidating value per Wesco share.

Others may think differently, but the foregoing approach seems reasonable to the writer as a way of estimating intrinsic value per Wesco share.

Thus, if the value of the advantage from the interest-free tax-deferral "loan" present was $20 per Wesco share at yearend 1996, and after-tax liquidating value was then about $176 per share (figures that seem rational to the writer), Wesco's intrinsic value per share would become about $196 per share at yearend 1996, up 32% from intrinsic value as guessed in a similar calculation at the end of 1995. And, finally, this reasonable-to-this-writer, $196-per-share figure for intrinsic per share value of Wesco stock should be compared with the $187 per share price at which Wesco stock was selling on December 31, 1996. This comparison indicates that Wesco stock was then selling about 5% below intrinsic value.

As Wesco's unrealized appreciation has continued to grow, it should be remembered that it is subject to market fluctuation, with no guaranty as to its ultimate full realization. Unrealized after-tax appreciation represents 70% of Wesco's shareholders' equity at 1996 yearend, versus 63% and 51% one and two years earlier.

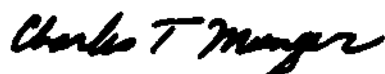
Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway.

All that said, we make no attempt to appraise relative attractiveness for investment of Wesco versus Berkshire Hathaway stock at present stock-market quotations.

We are not now pessimists, on a long-term basis, about business expansion. Despite present ebullient markets for entire businesses, making it hard for Wesco to find attractive opportunities, we do not believe that such opportunities will never come.

On January 15, 1997 Wesco increased its regular dividend from 26½ cents per share to 27½ cents per share, payable March 5, 1997, to shareholders of record as of the close of business on February 5, 1997.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.



Charles T. Munger
Chairman of the Board

March 7, 1997

WESCO FINANCIAL CORPORATION

Annual Report 1997

Form 10-K Annual Report 1997

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated ''normal'' net operating income (i.e., before irregularly occurring items shown in the table below) for the calendar year 1997 increased to $38,262,000 ($5.38 per share) from $30,720,000 ($4.32 per share) in the previous year.

Consolidated net income (i.e., after irregularly occurring items shown in the table below) increased to $101,809,000 ($14.30 per share) from $30,619,000 ($4.30 per share) in the previous year.

Wesco has three major subsidiaries: (1) Wesco-Financial Insurance Company (''Wes-FIC''), headquartered in Omaha and engaged principally in the reinsurance business, (2) The Kansas Bankers Surety Company (''KBS''), purchased by Wes-FIC in July 1996 and specializing in insurance products tailored to midwestern banks, and (3) Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended			
	December 31, 1997		December 31, 1996	
	Amount	Per Wesco Share[2]	Amount	Per Wesco Share[2]
''Normal'' net operating income of:				
Wes-FIC and KBS insurance businesses	$ 33,507	$ 4.71	$27,249	$3.83
Precision Steel businesses	3,622	.51	3,033	.43
All other ''normal'' net operating income[3]	1,133	.16	438	.06
	38,262	5.38	30,720	4.32
Realized net securities gains (losses)	62,697	8.80	(115)	(.02)
Gain on sales of foreclosed properties	850	.12	14	—
Wesco consolidated net income	$101,809	$14.30	$30,619	$4.30

(1) All figures are net of income taxes.

(2) Per-share data is based on 7,119,807 shares outstanding. Wesco has had no dilutive capital stock equivalents.

(3) After deduction of interest and other corporate expenses, and costs and expenses associated with delinquent loans and foreclosed real estate previously charged against Wesco's former Mutual Savings and Loan Association subsidiary. Income was from ownership of the Wesco headquarters office building, primarily leased to outside tenants, interest and dividend income from cash equivalents and marketable securities owned outside the insurance subsidiaries, and, in 1997, the reduction of loss reserves provided in prior years against possible losses on sales of foreclosed real estate.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

Wesco-Financial Insurance Company (''Wes-FIC'')

Wes-FIC's normal net income for 1997 was $33,507,000, versus $27,249,000 for 1996. The figures include $6,044,000 in 1997 and $2,288,000 in 1996 contributed by

The Kansas Bankers Surety Company (''KBS'') following its purchase by Wes-FIC early in the third quarter of 1996. The purchase of KBS is discussed in the section, ''The Kansas Bankers Surety Company,'' below.

At the end of 1997 Wes-FIC retained about $27.5 million in invested assets, offset by claims reserves, from its former reinsurance arrangement with Fireman's Fund Group. This arrangement was terminated August 31, 1989. However, it will take a long time before all claims are settled, and, meanwhile, Wes-FIC is being helped over many years by proceeds from investing ''float.''

We previously informed shareholders that Wes-FIC had entered into the business of super-cat reinsurance through retrocessions from the Insurance Group of Berkshire Hathaway, Wesco's ultimate parent. Wes-FIC's entry into the super-cat reinsurance business early in 1994 followed the large augmentation of its claims-paying capacity caused by its merger with Mutual Savings, the former savings and loan subsidiary of Wesco. In 1994, in recognition of Wes-FIC's sound financial condition, Standard and Poor's Corporation assigned to Wes-FIC the highest possible claims-paying-ability rating: AAA.

The super-cat reinsurance business, in which Wes-FIC is engaged, continues to be a very logical business for Wes-FIC. Wes-FIC has a large net worth in relation to annual premiums being earned. And this is exactly the condition rationally required for any insurance company planning to be a ''stand alone'' reinsurer covering super-catastrophe risks it can't safely pass on to others sure to remain solvent if a large super-catastrophe comes. Such a ''stand alone'' reinsurer must be a kind of Fort Knox, prepared occasionally, without calling on any other reinsurers for help, to pay out in a single year many times more than premiums coming in, as it covers losses from some super catastrophe worse than Hurricane Andrew. In short, it needs a balance sheet a lot like Wes-FIC's.

In connection with the retrocessions of super-cat reinsurance to Wes-FIC from the Berkshire Hathaway Insurance Group, the nature of the situation as it has evolved is such that Berkshire Hathaway, owning 100% of its Insurance Group and only 80% of Wesco and Wes-FIC, does not, for some philanthropic reason, ordinarily retrocede to Wes-FIC any reinsurance business that Berkshire Hathaway considers desirable and that is available only in amounts below what Berkshire Hathaway wants for itself on the terms offered. Instead, retrocessions occur only occasionally, under limited conditions and with some compensation to Berkshire Hathaway. Such retrocessions ordinarily happen only when (1) Berkshire Hathaway, for some reason (usually a policy of overall risk limitation), desires lower amounts of business than are available on the terms offered and (2) Wes-FIC has adequate capacity to bear the risk assumed and (3) Wes-FIC pays a fair ceding commission designed to cover part of the cost of getting and managing insurance business.

Generally, Berkshire Hathaway, in dealing with partly owned subsidiaries, tries to lean over a little backward in an attempt to observe what Justice Cardozo called ''the punctilio of an honor the most sensitive,'' but it cannot be expected to make

large and plain giveaways of Berkshire Hathaway assets or business to a partially owned subsidiary like Wes-FIC.

Given Berkshire Hathaway's unwillingness to make plain giveaways to Wes-FIC and reductions in opportunities in the super-cat reinsurance market in recent years, prospects are often poor for Wes-FIC's acquisition of retroceded super-cat reinsurance.

Moreover, Wesco shareholders should continue to realize that super-cat reinsurance is not for the faint of heart. A huge variation in annual results, with some very unpleasant future years for Wes-FIC, is inevitable.

But it is precisely what must, in the nature of things, be associated with these bad possibilities, with their huge and embarrassing adverse consequences in occasional years, that makes Wes-FIC like its way of being in the super-cat business. Buyers (particularly wise buyers) of super-cat reinsurance often want to deal with Berkshire Hathaway subsidiaries (possessing as they do the highest possible credit ratings and a reliable corporate personality) instead of other reinsurers less cautious, straightforward and well endowed. And many competing sellers of super-cat reinsurance are looking for a liberal ''intermediary's'' profit, hard to get because they must find a ''layoff'' reinsurer both (1) so smart that it is sure to stay strong enough to pay possible losses yet (2) so casual about costs that it is not much bothered by a liberal profit earned by some intermediary entity not willing to retain any major risk. Thus the forces in place can rationally be expected to cause acceptable long-term results for well-financed, disciplined decision makers, despite horrible losses in some years and other years of restricted opportunity to write business. And, again, we wish to repeat that we expect only acceptable long-term results. We see no possibility for bonanza.

It should also be noted that Wes-FIC, in the arrangements with the Insurance Group of Berkshire Hathaway, receives a special business-acquisition advantage from using Berkshire Hathaway's general reputation. Under all the circumstances, the 3% ceding commission now being paid seems more than fair to Wes-FIC. Certainly and obviously, Berkshire Hathaway would not offer terms so good to any other entity outside the Berkshire Hathaway affiliated group.

Finally, we repeat an important disclosure about Wes-FIC's super-cat-reinsurance-acquisition mechanics. It is impractical to have people in California make complex accept-or-reject decisions for Wes-FIC when retrocessions of reinsurance are offered by the Berkshire Hathaway Insurance Group. But, happily, the Berkshire Hathaway Insurance Group executives making original business-acquisition decisions are greatly admired and trusted by the writer and will be ''eating their own cooking.'' Under such circumstances, Wesco's and Wes-FIC's boards of directors, on the writer's recommendation, have simply approved automatic retrocessions of reinsurance to Wes-FIC as offered by one or more wholly owned Berkshire Hathaway subsidiaries. Each retrocession is to be accepted forthwith in writing in Nebraska by agents of Wes-FIC who are at the same time salaried employees of wholly owned subsidiaries of Berkshire Hathaway. Moreover, each retrocession will be made at a 3%-of-premiums ceding commission. Finally, two conditions must be

satisfied: (1) Wes-FIC must get 20% or less of the risk (before taking into account effects from the ceding commission) and (2) wholly owned Berkshire Hathaway subsidiaries must retain at least 80% of the identical risk (again, without taking into account effects from the ceding commission).

We will not ordinarily describe individual super-cat reinsurance contracts in full detail to Wesco shareholders. That would be contrary to our competitive interest. Instead, we will try to summarize reasonably any items of very large importance.

Will more reinsurance be later available to Wes-FIC through Berkshire Hathaway subsidiaries on the basis and using the automatic procedure we have above described? Well, we have often proved poor prognosticators. We can only say that we hope so and that more reinsurance should come, albeit irregularly and with long intermissions. No new contracts became available to Wes-FIC in 1997, although one super-cat contract of three-years' duration, written in 1996, became effective in January 1997, and another expired during the year. As of 1997 yearend, the one remaining super-cat contract, plus one other contract, not a super-cat contract, and renewed during the year, represented Wes-FIC's active reinsurance business.

We continue to examine other possible insurance-writing opportunities, and also insurance company acquisitions, like and unlike the purchase of KBS.

Wes-FIC is now a very strong insurance company, with very low costs, and, one way or another, in the future as in the past, we expect to continue to find and seize at least a few sensible insurance opportunities.

On super-cat reinsurance accepted by Wes-FIC to date (March 9, 1998) there has been no loss whatsoever that we know of, but some ''no-claims'' contingent commissions have been paid to original cessors of business (i.e., cessors not including Berkshire Hathaway). Super-cat underwriting profit of $2.3 million, before taxes, benefited 1997 earnings, versus $3.9 million in 1996. The balance of pre-tax underwriting profit, amounting to $2.8 million for 1997, came mostly from favorable revision of loss reserves on the old Fireman's Fund contract. Our accounting policy requires contract expiration before super-cat underwriting profit is recognized. Needless to say, we would not have similar reluctance to report losses before contract expirations.

The Kansas Bankers Surety Company (''KBS'')

KBS, purchased by Wes-FIC early in the third quarter of 1996 for approximately $80 million in cash, contributed $6,044,000 to the normal net operating income of the insurance businesses in 1997 and $2,288,000 in 1996, after reductions for goodwill amortization under consolidated accounting convention of $508,000, after taxes, in 1997 and $275,000 in 1996. The results of KBS have been combined with those of Wes-FIC, and are included in the foregoing table in the category, '' 'normal' net operating income of Wes-FIC and KBS insurance businesses.''

KBS was chartered in 1909 to underwrite deposit insurance for Kansas banks. Its offices are in Topeka, Kansas. Over the years its service has continued to adapt to the changing needs of the banking industry. Today its customer base, consisting mostly of small and medium-sized community banks, is spread throughout 25 mainly midwestern states. In addition to bank deposit guaranty bonds which insure deposits in excess of FDIC coverage, KBS also offers directors and officers indemnity policies, bank employment practices policies, bank annuity and mutual funds indemnity policies and bank insurance agents professional errors and omissions indemnity policies.

KBS is run by Donald Towle, President, assisted by 13 dedicated officers and employees.

Precision Steel

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, contributed $3,622,000 to normal net operating income in 1996, up 19% compared with $3,033,000 in 1996. The improvement in 1997 earnings was attributable mainly to a 15% increase in pounds of product sold. Revenues were up only 6.3%.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1997 continued to provide an excellent return on resources employed.

Tag Ends from Savings and Loan Days

All that now remains outside Wes-FIC but within Wesco as a consequence of Wesco's former involvement with Mutual Savings, Wesco's long-held savings and loan subsidiary, is a small real estate subsidiary, MS Property Company, that holds tag ends of assets and liabilities with a net book value of about $13 million. In 1997, MS Property Company shrunk by approximately half after sales of several foreclosed properties and contribution of $12,750,000 in cash to Wesco. MS Property Company's results of operations, immaterial versus Wesco's present size, are included in the foregoing breakdown of earnings within ''all other 'normal' net operating income.''

Of course, the main tag end from Wesco's savings and loan days is 28,800,000 shares of Federal Home Loan Mortgage Corporation (''Freddie Mac''), purchased by Mutual Savings for $72 million at a time when Freddie Mac shares could be lawfully owned only by a savings and loan association. This holding, with a market value of $1.2 billion at yearend 1997, now reposes in Wes-FIC.

All Other ''Normal'' Net Operating Income

All other ''normal'' net operating income, net of interest paid and general corporate expenses, increased to $1,133,000 in 1997 from $438,000 in 1996. Sources were (1) rents ($2,885,000 gross) from Wesco's Pasadena office property (leased almost entirely to outsiders, including CenFed Bank as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiaries, less (3) costs and expenses of

liquidating tag-end foreclosed real estate. In 1997, reversals of reserves for possible losses on sales of such tag-end real estate, expensed in prior years, benefited this category of earnings by about $1.1 million, after income tax effect. The 1997 and 1996 ''other 'normal' net operating income'' figures also include intercompany charges for interest expense ($172,000 and $298,000 after taxes, respectively) on borrowings from Wes-FIC principally made late in 1993 to facilitate the transfer of loans and foreclosed properties to MS Property Company. This intercompany interest expense does not affect Wesco's consolidated net income inasmuch as the same amount is included as interest income in Wes-FIC's ''normal'' net operating income.

Net Securities Gains and Losses

Wesco's earnings for 1997 contained securities gains of $62,697,000, after income taxes, versus losses of $115,000, after income taxes, in 1996. Of the 1997 figure, only $93,000 was realized through the sale of securities; the balance, $62,604,000, resulted from the exchange of the preferred and common shares of Salomon Inc (''Salomon'') owned by Wesco for preferred and common shares of Travelers Group Inc. (''Travelers'') late in 1997 in connection with the merger of Salomon with a subsidiary of Travelers. Accounting standards promulgated by the Financial Accounting Standards Board require that the fair (market) value of shares received in such an exchange be recorded as the new cost basis as of the date of the exchange, with the difference, after appropriate reserves for future income tax on the gain, recognized in the financial statements as a realized after-tax gain. For income tax purposes the exchange is recorded at the original cost of the securities exchanged; no gain is reported on the tax return, and no taxes are yet due.

Although the realized gain had a material impact on Wesco's reported earnings, *it had a very minor impact on Wesco's shareholders' equity*. Inasmuch as $48,504,000 of the after-tax gain had previously been reflected in the unrealized gain component of Wesco's shareholders' equity as of September 30, 1997, that amount was merely switched from unrealized gains to retained earnings, another component of shareholders' equity.

Convertible Preferred Stockholdings

At the end of 1997, Wesco and its subsidiaries owned $52 million, at original cost, in convertible preferred stocks of Travelers Group Inc. (''Travelers'') and US Airways Group, Inc. (''US Air''). The Travelers preferred stock was received in late 1997 (see the preceding section) in exchange for the Wesco group's remaining shares of Salomon Inc preferred stock, which originally cost $40 million, and whose cost was adjusted upwards to $90 million as of the date of the exchange. The US Air preferred stock originally cost $12 million; that figure was adjusted down to $3 million when we decided in 1994 that an other-than-temporary decline in the value of its stock had occurred. Both issues require redemption at par value or conversion to common stock within the next two years.

The investments are carried on Wesco's consolidated balance sheet at fair value, with any difference between *adjusted* cost and market value included in shareholders' equity, net of income tax effect, without affecting reported net income, according to accounting convention. Following is a summary of these investments in convertible preferred stocks at yearend 1997:

Security	Preferred Dividend Rate	Par Value of Holding	Conversion Price at Which Par Value May Be Exchanged for Common Stock	Market Price of Common Stock on 12/31/97	12/31/97 Yearend Carrying Value of Holding
Travelers Group Inc. . . .	9.00%	$40 Million	$22.42	$53.875	$ 96 Million
US Airways Group, Inc.	9.25%	12 Million	38.74	62.50	19.2 Million

These convertible preferred stocks were obtained at the same time Wesco's parent corporation, Berkshire Hathaway, obtained additional amounts of the same stocks at the same price per share. The preferred stock of Travelers was obtained in exchange for the remaining shares of preferred stock of Salomon Inc which Wesco and its subsidiaries had acquired in 1987. On October 31, 1995, in accordance with the terms of its convertible preferred stock, Salomon redeemed $20 million par value of its preferred shares owned by Wesco at cost plus accrued dividends. On October 31, 1996 and October 31, 1997, Wesco converted an aggregate of $40 million par value of its remaining preferred shares of Salomon to 1,052,628 shares of Salomon common stock, with Wesco continuing to hold par value of $40 million of Salomon preferred stock. On November 28, 1997, Wesco and its subsidiaries received $40 million par value of Travelers 9% preferred stock plus 1,784,204 shares of Travelers common stock, in exchange for the Salomon holdings, in connection with a merger of Salomon into Travelers. Fair value of the Travelers preferred and common shares, carried on Wesco's consolidated balance sheet in the categories ''securities with fixed maturities'' and ''marketable equity securities,'' were $96.0 million and $96.1 million, respectively, at yearend 1997, versus the adjusted costs of $90.0 and $90.8 million, respectively, at which they were carried.

US Air has called its convertible preferred stock for redemption on March 15, 1998. On March 13, 1998, Wesco converted its shares, acquired for $12 million in 1989 and written down to an adjusted cost of $3 million in 1994, to 309,718 shares of US Air common.

In previous years we noted that ''few, if any, investors have ever prospered mightily from investing in convertible preferred stocks of leading corporations.'' Our experience proves, yet again, what poor prognosticators we are. We estimate that (1) our investment in preferred and common stock of Travelers, acquired in 1997 through its merger with Salomon, in which we originally invested $80 million, net, was worth about $112.1 million more than we paid, and (2) our $12 million US Air holding was at yearend 1997 worth about $7.2 million more than we paid. These figures when combined created $119.3 million more than actual cost. In addition, Wesco's investment in convertible preferred stock of The Gillette Company, made in 1989 at cost of $40 million, and converted into Gillette common stock in 1991 is carried at a $321.4 million yearend market value in Wesco's consolidated 1997 balance sheet. This

is $281.4 million more than the investment cost. Also, in 1995, Wesco realized a gain of $6.9 million, before taxes ($4.2 million after taxes), on sale of its $23 million investment in preferred stock of Champion International Corporation.

Consolidated Balance Sheet And Related Discussion

As indicated in the accompanying financial statements, Wesco's net worth increased, as accountants compute it under their conventions, to $1.76 billion ($248 per Wesco share) at yearend 1997 from $1.25 billion ($176 per Wesco share) at yearend 1996.

The $513 million increase in reported net worth in 1997 was the result of three factors: (1) $419 million resulting from continued net appreciation of investments after provision for future taxes on capital gains; plus (2) $94 million from retention of 1997 net income, including $63 million realized on the exchange of Salomon stock for Travelers stock, discussed above; less (3) dividends paid.

The foregoing $248-per-share book value approximates liquidation value assuming that all Wesco's non-security assets would liquidate, after taxes, at book value. Probably, this assumption is too conservative. But our computation of liquidation value is unlikely to be too low by more than two or three dollars per Wesco share, because (1) the liquidation value of Wesco's consolidated real estate holdings (where interesting potential now lies almost entirely in Wesco's equity in its office property in Pasadena) containing only 125,000 net rentable square feet, and (2) unrealized appreciation in other assets (primarily Precision Steel) cannot be large enough, in relation to Wesco's overall size, to change very much the overall computation of after-tax liquidating value.

Of course, so long as Wesco does not liquidate, and does not sell any appreciated assets, it has, in effect, an interest-free ''loan'' from the government equal to its deferred income taxes on both the unrealized gains and gains deferred from the merger of Salomon into Travelers in 1997, subtracted in determining its net worth. This interest-free ''loan'' from the government is at this moment working for Wesco shareholders and amounted to about $102 per Wesco share at yearend 1997.

However, some day, perhaps soon, major parts of the interest-free ''loan'' must be paid as assets are sold. Therefore, Wesco's shareholders have no perpetual advantage creating value for them of $102 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than $102 per Wesco share. In the writer's judgment, the value of Wesco's advantage from its temporary, interest-free ''loan'' was probably about $25 per Wesco share at yearend 1997.

After the value of the advantage inhering in the interest-free ''loan'' is estimated, a reasonable approximation can be made of Wesco's intrinsic value per share. This approximation is made by simply adding (1) the value of the advantage from the interest-free ''loan'' per Wesco share and (2) liquidating value per Wesco share. Others may think differently, but the foregoing approach seems reasonable to the writer as a way of estimating intrinsic value per Wesco share.

Thus, if the value of the advantage from the interest-free tax-deferral ''loan'' present was $25 per Wesco share at yearend 1997, and after-tax liquidating value was then about $248 per share (figures that seem rational to the writer), Wesco's intrinsic value per share would become about $273 per share at yearend 1997, up 39% from intrinsic value as guessed in a similar calculation at the end of 1996. And, finally, this reasonable-to-this-writer, $273-per-share figure for intrinsic per share value of Wesco stock should be compared with the $300 per share price at which Wesco stock was selling on December 31, 1997. This comparison indicates that Wesco stock was then selling about 10% above intrinsic value.

As Wesco's unrealized appreciation has continued to grow in frothy markets for securities, it should be remembered that it is subject to market fluctuation, possibly dramatic on the downside, with no guaranty as to its ultimate full realization. Unrealized after-tax appreciation represents 73% of Wesco's shareholders' equity at 1997 yearend), versus 70% and 63% one and two years earlier.

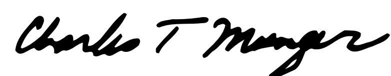
Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway. Moreover, the quality disparity in book value's intrinsic merits has, in recent years, been widening in favor of Berkshire Hathaway.

All that said, we make no attempt to appraise relative attractiveness for investment of Wesco versus Berkshire Hathaway stock at present stock-market quotations.

We are not now pessimists, on a long-term basis, about business expansion. Despite present super-ebullient markets for entire businesses, making it hard for Wesco to find attractive opportunities, we do not believe that such opportunities will never come.

On January 28, 1998 Wesco increased its regular dividend from 27½ cents per share to 28½ cents per share, payable March 11, 1998, to shareholders of record as of the close of business on February 11, 1998.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.



Charles T. Munger
Chairman of the Board

March 13, 1998

WESCO FINANCIAL CORPORATION

Annual Report 1998

Form 10-K Annual Report 1998

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated ''normal'' net operating income (i.e., before irregularly occurring items shown in the table below) for the calendar year 1998 decreased to $37,622,000 ($5.28 per share) from $38,262,000 ($5.38 per share) in the previous year.

Consolidated net income (i.e., after irregularly occurring items shown in the table below) decreased to $71,803,000 ($10.08 per share) from $101,809,000 ($14.30 per share) in the previous year.

Wesco has three major subsidiaries: (1) Wesco-Financial Insurance Company (''Wes-FIC''), headquartered in Omaha and engaged principally in the reinsurance business, (2) The Kansas Bankers Surety Company (''KBS''), owned by Wes-FIC and specializing in insurance products tailored to midwestern banks, and (3) Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended			
	December 31, 1998		December 31, 1997	
	Amount	Per Wesco Share[2]	Amount	Per Wesco Share[2]
''Normal'' net operating income of:				
Wes-FIC and KBS insurance businesses	$34,654	$ 4.87	$ 33,507	$ 4.71
Precision Steel businesses	3,154	.44	3,622	.51
All other ''normal'' net operating income (loss)[3]	(186)	(.03)	1,133	.16
	37,622	5.28	38,262	5.38
Realized net securities gains	33,609	4.72	62,697	8.80
Gain on sales of foreclosed properties	572	.08	850	.12
Wesco consolidated net income	$71,803	$10.08	$101,809	$14.30

(1) All figures are net of income taxes.

(2) Per-share data is based on 7,119,807 shares outstanding. Wesco has had no dilutive capital stock equivalents.

(3) After deduction of interest and other corporate expenses, and costs and expenses associated with foreclosed real estate previously charged against Wesco's former Mutual Savings and Loan Association subsidiary. Income was from ownership of the Wesco headquarters office building, primarily leased to outside tenants, interest and dividend income from cash equivalents and marketable securities owned outside the insurance subsidiaries, and, in 1997, the reduction of loss reserves provided in prior years against possible losses on sales of foreclosed real estate.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

Wesco-Financial Insurance Company (''Wes-FIC'')

Wes-FIC's normal net income for 1998 was $34,654,000, versus $33,507,000 for 1997. The figures include $4,987,000 in 1998 and $6,044,000 in 1997 contributed by The Kansas Bankers Surety Company (''KBS''), owned by Wes-FIC since 1996. KBS is discussed in the section, ''The Kansas Bankers Surety Company,'' below.

At the end of 1998 Wes-FIC retained about $24 million in invested assets, offset by claims reserves, from its former reinsurance arrangement with Fireman's Fund Group. This arrangement was terminated August 31, 1989. However, it will take a long time before all claims are settled, and, meanwhile, Wes-FIC is being helped over many years by proceeds from investing ''float.''

We previously informed shareholders that Wes-FIC had entered into the business of super-cat reinsurance through retrocessions from the Insurance Group of Berkshire Hathaway, Wesco's ultimate parent. Wes-FIC's entry into the super-cat reinsurance business early in 1994 followed the large augmentation of its claims-paying capacity caused by its merger with Mutual Savings, the former savings and loan subsidiary of Wesco. In 1994, in recognition of Wes-FIC's sound financial condition, Standard and Poor's Corporation assigned to Wes-FIC the highest possible claims-paying-ability rating: AAA.

The super-cat reinsurance business, in which Wes-FIC is engaged, continues to be a very logical business for Wes-FIC. Wes-FIC has a large net worth in relation to annual premiums being earned. And this is exactly the condition rationally required for any insurance company planning to be a ''stand alone'' reinsurer covering super-catastrophe risks it can't safely pass on to others sure to remain solvent if a large super-catastrophe comes. Such a ''stand alone'' reinsurer must be a kind of Fort Knox, prepared occasionally, without calling on any other reinsurers for help, to pay out in a single year many times more than premiums coming in, as it covers losses from some super catastrophe worse than Hurricane Andrew. In short, it needs a balance sheet a lot like Wes-FIC's.

In connection with the retrocessions of super-cat reinsurance to Wes-FIC from the Berkshire Hathaway Insurance Group, the nature of the situation as it has evolved is such that Berkshire Hathaway, owning 100% of its Insurance Group and only 80% of Wesco and Wes-FIC, does not, for some philanthropic reason, ordinarily retrocede to Wes-FIC any reinsurance business that Berkshire Hathaway considers desirable and that is available only in amounts below what Berkshire Hathaway wants for itself on the terms offered. Instead, retrocessions occur only occasionally, under limited conditions and with some compensation to Berkshire Hathaway. Such retrocessions ordinarily happen only when (1) Berkshire Hathaway, for some reason (usually a policy of overall risk limitation), desires lower amounts of business than are available on the terms offered and (2) Wes-FIC has adequate capacity to bear the risk assumed and (3) Wes-FIC pays a fair ceding commission designed to cover part of the cost of getting and managing insurance business.

Generally, Berkshire Hathaway, in dealing with partly owned subsidiaries, tries to lean over a little backward in an attempt to observe what Justice Cardozo called ''the punctilio of an honor the most sensitive,'' but it cannot be expected to make large and plain giveaways of Berkshire Hathaway assets or business to a partially owned subsidiary like Wes-FIC.

Given Berkshire Hathaway's unwillingness to make plain giveaways to Wes-FIC and reductions in opportunities in the super-cat reinsurance market in recent years, prospects are often poor for Wes-FIC's acquisition of retroceded super-cat reinsurance.

Moreover, Wesco shareholders should continue to realize that super-cat reinsurance is not for the faint of heart. A huge variation in annual results, with some very unpleasant future years for Wes-FIC, is inevitable.

But it is precisely what must, in the nature of things, be associated with these bad possibilities, with their huge and embarrassing adverse consequences in occasional years, that makes Wes-FIC like its way of being in the super-cat business. Buyers (particularly wise buyers) of super-cat reinsurance often want to deal with Berkshire Hathaway subsidiaries (possessing as they do the highest possible credit ratings and a reliable corporate personality) instead of other reinsurers less cautious, straightforward and well endowed. And many competing sellers of super-cat reinsurance are looking for a liberal ''intermediary's'' profit, hard to get because they must find a ''layoff'' reinsurer both (1) so smart that it is sure to stay strong enough to pay possible losses yet (2) so casual about costs that it is not much bothered by a liberal profit earned by some intermediary entity not willing to retain any major risk. Thus the forces in place can rationally be expected to cause acceptable long-term results for well-financed, disciplined decision makers, despite horrible losses in some years and other years of restricted opportunity to write business. And, again, we wish to repeat that we expect only acceptable long-term results. We see no possibility for bonanza.

It should also be noted that Wes-FIC, in the arrangements with the Insurance Group of Berkshire Hathaway, receives a special business-acquisition advantage from using Berkshire Hathaway's general reputation. Under all the circumstances, the 3% ceding commission now being paid seems more than fair to Wes-FIC. Certainly and obviously, Berkshire Hathaway would not offer terms so good to any other entity outside the Berkshire Hathaway affiliated group.

Finally, we repeat an important disclosure about Wes-FIC's super-cat-reinsurance-acquisition mechanics. It is impractical to have people in California make complex accept-or-reject decisions for Wes-FIC when retrocessions of reinsurance are offered by the Berkshire Hathaway Insurance Group. But, happily, the Berkshire Hathaway Insurance Group executives making original business-acquisition decisions are greatly admired and trusted by the writer and will be ''eating their own cooking.'' Under such circumstances, Wesco's and Wes-FIC's boards of directors, on the writer's recommendation, have simply approved automatic retrocessions of reinsurance to Wes-FIC as offered by one or more wholly owned Berkshire

Hathaway subsidiaries. Each retrocession is to be accepted forthwith in writing in Nebraska by agents of Wes-FIC who are at the same time salaried employees of wholly owned subsidiaries of Berkshire Hathaway. Moreover, each retrocession will be made at a 3%-of-premiums ceding commission. Finally, two conditions must be satisfied: (1) Wes-FIC must get 20% or less of the risk (before taking into account effects from the ceding commission) and (2) wholly owned Berkshire Hathaway subsidiaries must retain at least 80% of the identical risk (again, without taking into account effects from the ceding commission).

We will not ordinarily describe individual super-cat reinsurance contracts in full detail to Wesco shareholders. That would be contrary to our competitive interest. Instead, we will try to summarize reasonably any items of very large importance.

Will more reinsurance be later available to Wes-FIC through Berkshire Hathaway subsidiaries on the basis and using the automatic procedure we have above described? Well, we have often proved poor prognosticators. We can only say that we hope so and that more reinsurance should come, albeit irregularly and with long intermissions. No new contracts became available to Wes-FIC in 1998. As of 1998 yearend, the one remaining super-cat contract, plus one other contract, not a super-cat contract, represented Wes-FIC's active reinsurance business.

We continue to examine other possible insurance-writing opportunities, and also insurance company acquisitions, like and unlike the purchase of KBS.

Wes-FIC is now a very strong insurance company, with very low costs, and, one way or another, in the future as in the past, we expect to continue to find and seize at least a few sensible insurance opportunities.

On super-cat reinsurance accepted by Wes-FIC to date (March 8, 1999) there has been no loss whatsoever that we know of, but some ''no-claims'' contingent commissions have been paid to original cessors of business (i.e., cessors not including Berkshire Hathaway). Super-cat underwriting profit of $1.4 million, before taxes, benefited 1998 earnings, versus $2.3 million in 1997. The balance of pre-tax underwriting profit amounted to $1.9 million for 1998 and $2.8 million for 1997. These figures came mostly from favorable revision of loss reserves on the old Fireman's Fund contract.

The Kansas Bankers Surety Company (''KBS'')

KBS, purchased by Wes-FIC in 1996 for approximately $80 million in cash, contributed $4,987,000 to the normal net operating income of the insurance businesses in 1998 and $6,044,000 in 1997, after reductions for goodwill amortization under consolidated accounting convention of $782,000 each year. The results of KBS have been combined with those of Wes-FIC, and are included in the foregoing table in the category, '' 'normal' net operating income of Wes-FIC and KBS insurance businesses.''

KBS was chartered in 1909 to underwrite deposit insurance for Kansas banks. Its offices are in Topeka, Kansas. Over the years its service has continued to adapt to the

changing needs of the banking industry. Today its customer base, consisting mostly of small and medium-sized community banks, is spread throughout 25 mainly midwestern states. In addition to bank deposit guaranty bonds which insure deposits in excess of FDIC coverage, KBS also offers directors and officers indemnity policies, bank employment practices policies, bank annuity and mutual funds indemnity policies and bank insurance agents professional errors and omissions indemnity policies.

The principal change in KBS's operations in 1998 was a large reduction in insurance premiums ceded to reinsurers, effective January 1, 1998. The increased volume of business retained (94% in 1998 versus 58% in 1997) accompanied reduced underwriting income during 1998. However, KBS's combined ratio remained much better than average for insurers, at 62.2% for 1998, versus 37.2% for 1997 and 29.3% for 1996, and we expect volatile but favorable long-term effects from increased insurance retained. Part of KBS's continuing insurance volume is now ceded through reinsurance to other Berkshire subsidiaries under reinsurance arrangements whereunder such other Berkshire subsidiaries take 50% and unrelated reinsurers take the other 50%.

KBS is run by Donald Towle, President, assisted by 15 dedicated officers and employees.

Precision Steel

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, contributed $3,154,000 to normal net operating income in 1998, compared with $3,622,000 in 1997. The decrease in profit occurred as revenues decreased 2%, despite a 5% increase in pounds of product sold, and was attributable mainly to expenditures necessitated to upgrade computers and computer systems to ensure that Precision Steel's order-taking and other data processing systems continue to function accurately beyond December 31, 1999.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1998 continued to provide an excellent return on resources employed.

Tag Ends from Savings and Loan Days

All that now remains outside Wes-FIC but within Wesco as a consequence of Wesco's former involvement with Mutual Savings, Wesco's long-held savings and loan subsidiary, is a small real estate subsidiary, MS Property Company, that holds tag ends of assets and liabilities with a net book value of about $13 million. MS Property Company's results of operations, immaterial versus Wesco's present size, are included in the foregoing breakdown of earnings within "all other 'normal' net operating income (loss)."

Of course, the main tag end from Wesco's savings and loan days is 28,800,000 shares of Freddie Mac, purchased by Mutual Savings for $72 million at a time when Freddie Mac shares could be lawfully owned only by a savings and loan

association. This holding, with a market value of $1.9 billion at yearend 1998, now reposes in Wes-FIC.

All Other "Normal" Net Operating Income or Loss

All other ''normal'' net operating income or loss, net of interest paid and general corporate expenses, decreased to an after-tax loss of $186,000 in 1998 from an after-tax profit of $1,133,000 in 1997. Sources were (1) rents ($2,921,000 gross) from Wesco's Pasadena office property (leased almost entirely to outsiders, including California Federal Bank as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiaries, less (3) costs and expenses of liquidating tag-end foreclosed real estate. Income in 1998 was lower because (1) reversals of reserves for possible losses on sales of such tag end real estate, expensed in prior years, benefited earnings by about $1.1 million in 1997, and (2) lower dividends were received in 1998 after forced conversion of preferred stock of Citigroup Inc. (''Citigroup'') into lower-dividend-paying common stock. The 1998 and 1997 ''other 'normal' net operating income or loss'' figures also include intercompany charges for interest expense ($102,000 and $172,000 after taxes, respectively) on borrowings from Wes-FIC. This intercompany interest expense does not affect Wesco's consolidated net income inasmuch as the same amount is included as interest income in Wes-FIC's ''normal'' net operating income.

Net Securities Gains and Losses

Wesco's earnings contained securities gains of $33,609,000, after income taxes, for 1998, versus $62,697,000, after taxes, for 1997. The entire 1998 figure resulted from sales of marketable securities. Of the 1997 figure, only $93,000 was realized through the sale of securities; the balance, $62,604,000, resulted from the exchange of the preferred and common shares of Salomon Inc (''Salomon'') owned by Wesco for preferred and common shares of The Travelers Group Inc. (''Travelers'') late in 1997 in connection with the merger of Salomon with a subsidiary of Travelers. Accounting standards require that the fair (market) value of shares received in such an exchange be recorded as the new cost basis as of the date of the exchange, with the difference, after appropriate reserves for future income tax on the gain, recognized in the financial statements as a realized after-tax gain. For income tax purposes the exchange is recorded at the original cost of the securities exchanged; no gain is reported on the tax return until the securities are sold.

Although the realized gains materially impacted Wesco's reported earnings for each year, *they had a very minor impact on Wesco's shareholders' equity*. Inasmuch as the greater portion of each year's realized gains had previously been reflected in the unrealized gain component of Wesco's shareholders' equity, those amounts were merely switched from unrealized gains to retained earnings, another component of shareholders' equity.

Convertible Preferred Stockholdings

At the end of 1998, Wesco and its subsidiaries owned $20,000,000, at original cost, in convertible preferred stock which by merger of Travelers and Citicorp late in 1998 became convertible preferred stock of Citigroup. The Travelers preferred stock, itself, was received in 1997 (see the preceding section) in exchange for the Wesco group's remaining shares of Salomon preferred stock, which originally cost $20,000,000, and whose cost was adjusted upwards to $45,000,000 as of the date of the exchange. The issue requires redemption at par value of $20,000,000 on October 31, 1999, if not converted to 892,105 shares of common stock before that date. The investment is carried on Wesco's consolidated balance sheet at fair value of $44,000,000 as of December 31, 1998, the approximate market value of the common shares at that date, with the $1,000,000 difference between *its adjusted* cost and market value deducted from shareholders' equity, net of income tax effect, without affecting reported net income, according to accounting convention. The convertible preferred stock was obtained at the same time Wesco's parent corporation, Berkshire Hathaway, obtained additional amounts of the same stock at the same price per share.

Through yearend 1997, Wesco's consolidated financial statements reflected an investment in 9.25% convertible preferred stock of US Airways Group, Inc., acquired by Wesco at par of $12,000,000 in 1989; that figure was adjusted down to $3,000,000 when we decided in 1994 that an other-than-temporary decline in the value of its stock had occurred. Early in 1998, US Airways called the preferred stock for redemption. Prior to the effective date, Wesco converted its preferred stock investment to 309,718 shares of US Airways common stock and sold the latter for $21,738,000, realizing a gain of $18,738,000 for financial statement purposes ($12,180,000 after taxes). For tax return purposes, however, only $9,738,000 of gain ($6,330,000 after taxes) will be realized, because the $9,000,000 writedown in 1994 was not deductible.

Consolidated Balance Sheet And Related Discussion

As indicated in the accompanying financial statements, Wesco's net worth increased, as accountants compute it under their conventions, to $2.22 billion ($312 per Wesco share) at yearend 1998 from $1.76 billion ($248 per Wesco share) at yearend 1997.

The $459.5 million increase in reported net worth in 1998 was the result of three factors: (1) $395.8 million resulting from continued net appreciation of investments after provision for future taxes on capital gains; plus (2) $71.8 million from 1998 net income; less (3) $8.1 million in dividends paid.

The foregoing $312-per-share book value approximates liquidation value assuming that all Wesco's non-security assets would liquidate, after taxes, at book value. Probably, this assumption is too conservative. But our computation of liquidation value is unlikely to be too low by more than two or three dollars per Wesco share, because (1) the liquidation value of Wesco's consolidated real estate holdings

(where interesting potential now lies almost entirely in Wesco's equity in its office property in Pasadena) containing only 125,000 net rentable square feet, and (2) unrealized appreciation in other assets (primarily Precision Steel) cannot be large enough, in relation to Wesco's overall size, to change very much the overall computation of after-tax liquidating value.

Of course, so long as Wesco does not liquidate, and does not sell any appreciated assets, it has, in effect, an interest-free ''loan'' from the government equal to its deferred income taxes on the unrealized gains, subtracted in determining its net worth. This interest-free ''loan'' from the government is at this moment working for Wesco shareholders and amounted to about $127 per Wesco share at yearend 1998.

However, some day, perhaps soon, major parts of the interest-free ''loan'' must be paid as assets are sold. Therefore, Wesco's shareholders have no perpetual advantage creating value for them of $127 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than $127 per Wesco share. In the writer's judgment, the value of Wesco's advantage from its temporary, interest-free ''loan'' was probably about $30 per Wesco share at yearend 1998.

After the value of the advantage inhering in the interest-free ''loan'' is estimated, a reasonable approximation can be made of Wesco's intrinsic value per share. This approximation is made by simply adding (1) the value of the advantage from the interest-free ''loan'' per Wesco share and (2) liquidating value per Wesco share. Others may think differently, but the foregoing approach seems reasonable to the writer as a way of estimating intrinsic value per Wesco share.

Thus, if the value of the advantage from the interest-free tax-deferral ''loan'' present was $30 per Wesco share at yearend 1998, and after-tax liquidating value was then about $312 per share (figures that seem rational to the writer), Wesco's intrinsic value per share would become about $342 per share at yearend 1998, up 25% from intrinsic value as guessed in a similar calculation at the end of 1997. And, finally, this reasonable-to-this-writer, $342-per-share figure for intrinsic per share value of Wesco stock should be compared with the $354¾ per share price at which Wesco stock was selling on December 31, 1998. This comparison indicates that Wesco stock was then selling about 4% above intrinsic value.

As Wesco's unrealized appreciation has continued to grow in frothy markets for securities, it should be remembered that it is subject to market fluctuation, possibly dramatic on the downside, with no guaranty as to its ultimate full realization. Unrealized after-tax appreciation represents 76% of Wesco's shareholders' equity at 1998 yearend), versus 73% and 70% one and two years earlier.

Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues

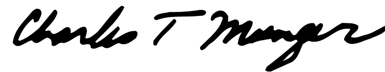
plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway. Moreover, the quality disparity in book value's intrinsic merits has, in recent years, been widening in favor of Berkshire Hathaway.

All that said, we make no attempt to appraise relative attractiveness for investment of Wesco versus Berkshire Hathaway stock at present stock-market quotations.

We are not now pessimists, on a long-term basis, about business expansion. Despite present super-ebullient markets for entire businesses, making it hard for Wesco to find attractive opportunities, we do not believe that such opportunities will never come.

On January 13, 1999 Wesco increased its regular dividend from 28½ cents per share to 29½ cents per share, payable March 10, 1999, to shareholders of record as of the close of business on February 10, 1999.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.



Charles T. Munger
Chairman of the Board

March 8, 1999

1999 Wesco Shareholder Meeting, Pasadena CA 1999

By simpleinvestor posted on www.fool.com | about stocks: BRK.A / BRK.B / WSC

Following note was found on Motley Food (www.fool.com) website, posted by user name "simpleinvestor"

FREE INVESTMENT SEMINAR

The last time I visited Pasadena in 1977, Michigan lost the Rose Bowl to USC. My team got a football lesson then and when I returned last week a lucky few got a world class investment lesson.

The Wesco annual meeting in Pasadena, California is more of a free investment seminar held in a classroom for 200 students. The Omaha meeting is more of a spectacle of financial advice staged in an arena of 15,000 participants. In the future plan to attend both but my preference is Pasadena. In Omaha you meet fellow shareholders in an arena. In Pasadena you learn in a classroom (University Club).

Charlie Munger was a different advisor. Never once did he say, "I have nothing further to add." He spoke like a college professor with candor and experience. With such a small audience it was easy to ask questions. Some even had the opportunity to ask more than once. It's an open meeting. No ticket required.

Lou Simpson was in attendance (his first) and answered some GEICO questions. The tables were turned and Mr. Munger asked Alice Schroeder from PaineWebber some questions.

The entire meeting lasted 3 hours and I was able to take as many notes as the Omaha meeting. The most significant thing that I learned was a better comprehension of technology and the Internet. And an unexpected surprise tour the next day.

When you turn off the noise coming at you from all angles in the investment world, you need to know when to turn your senses back on. In Pasadena you could open your eyes and ears and listen to every question and remember every answer.

Here's a summary of my notes and observations.

1. GOOD IDEAS CAN HURT YOU. For as much as Mr. Munger and Mr. Buffett claim to not consider technology in their circle of competence, I learned a new way of looking at tech. When you come across a bad idea you and everyone else know it's bad, so it can't hurt you. On the other hand when you come across a good idea it's easy to over do it. Mr. Munger liken the Internet to railroads, refrigeration, radio, television and air conditioning. Great technological advances for mankind but not necessarily great investments. Ben Graham said it's not the bad ideas that do you in. It's the good ideas that get you. You can't ignore it and it's easy to over do it. Mr. Munger stressed that technology has opportunities but it's potentially way over done.

2. THERE'S ALWAYS SOMETHING THAT PEOPLE GO CRAZY OVER. In the 1920's it was the over-leveraged stock market and the Florida land speculation. In the 60's it was junk stocks, overvaluations and efficient market theorists. EMT reached insanity levels. Buffett closed his partnership in the 60's because of too much speculation. Which led to junk bonds of the 80's. Today it's the Internet stocks. Mr. Munger's prediction: immense losses will be realized with Internet investments. This is a major reason to have experienced money managers making decisions for you.

3. LESSONS FROM JAPAN. Looked what happened to Japan. A clannish people, smart, hard working and prosperous society. They were led into excessive land speculation, bank fictional accounting, and stock market excesses. The so called 'wealth effect' became a narcotic that eventually crashed. Mr. Munger told the story of Bank of America selling their modest Tokyo executive house for $55 million cash during the height of Japans over-exuberance. Japan attempted to fix their economy with classic Keyesian economic theory; interest rates to zero and high debt but still suffers from a long lasting depression.

4. TELEVISION COMPARED TO THE INTERNET. Mr. Munger considers the invention of the television more impactful than the Internet. Instant color pictures brought into the home could be captured by a few broadcasting networks, which led to good investment returns. Any single provider will soon wire the Internet into the home with unlimited bandwidth but no monopoly.

5. HOT STOCK TIPS VERSUS INVESTMENT LESSONS. One former stockbroker in attendance walked away from the annual meeting (free investment seminar) with a hot stock tip. Lou Simpson and Mr. Munger talked about Mercury Insurance and their respect for the fellow running it. Some took that as a stock tip. I interpreted it as something that I didn't understand and was glad to have experts in charge of making investment decisions for me. If Charlie or Lou thought Mercury was a great investment I am confident they would buy it on my behalf. We're partners in business not competitors.

6. CONCENTRATED PORTFOLIO. Mr. Munger, Mr. Simpson and Mr. Buffett's investments all have one thing in common. They believe in concentrating their portfolios. If you are confident enough to select 3 to 10 common stocks for the long term you too can compete against this distinguished group. If you need to diversify out of ignorance its best to own a low cost and tax efficient index fund. Mr. Munger took a poll of the audience and 90 percent owned fewer than 12 common stocks. Berkshire has 60 percent of its common stock holdings in 3 stocks. Wesco has 95 percent of its common stock holdings in just 3 stocks.

7. DON'T BELIEVE THE BERKSHIRE RUMORS. Mr. Munger said that Berkshire Hathaway is not buying REITS but Mr. Buffett was personally buying some. REITs are more suitable for personal investment because of the dividends. Munger teased Buffett saying that buying REITs was resorting to cigar butt investing and a need to support the lifestyle of his globetrotting wife.

8. GEN RE. Very happy with the way things are going with General Re. Cologne Re charge against earnings was a surprise and not an intentional deception by management.

9. STOCK OPTIONS. Berkshire handles executive compensation the honest way by declaring it as an expense on the earnings statement. When Berkshire acquired Gen Re it declared upfront $63 million of compensation expenses to inform shareholders as to the true costs against earnings. Mr. Munger considers himself the sole voice against a widely used practice of deceiving the shareholders with stock options. The typical stock option program is corrupt accounting and is like a Ponzi scheme. An investment farce where high profits are promised from fictitious sources and early investors are paid off with funds raised from later ones. The average stock option program bleeds 12 –14 percent of profits from shareholders. Mr. Munger thinks the accounting profession bends too much and should have higher standards like the engineering profession. Better standards are needed.

10. YEAR-END CASH. Berkshire loves companies that have earnings at the end of the year in cash. Mr. Munger compared this desire with a friend who had a construction equipment firm that had all his annual earnings in accounts receivable and equipment in the yard at the end of the year.

11. FOUNDATION MANAGEMENT. One word for it – preposterous. Mr. Munger likens it to a mad hatter's tea party. Too many layers. Consultants hired to hire more consultants. No value added.

12. ANALYST COVERAGE. Welcomed Alice Schroeder of PaineWebber and took the opportunity to ask her some questions. She reassured shareholders that she wasn't given any special treatment. Information that Alice used in her writings is available to all owners in the annual reports. Berkshire releases all public information on the Internet after market hours for all interested parties so no one has inside information.

13. CASUALTY BUSINESS. It's going to get more competitive. Mr. Munger compared the casualty insurance business to rowing against a strong current but Berkshire has a very large well-equipped boat.

14. GEICO COMPETION. Mr. Munger called on Lou Simpson to explain GEICO's competition. He said in Southern California its 20th Century and Mercury. Elsewhere its Progressive and potentially AIG, and GE (Colonial Penn), State Farm, and Allstate. Business will be tougher in the next 5 years, but Mr. Munger likes what's happening at GEICO. It's the biggest advertiser on cable.

15. ERRORS OF OMISSION. Mr. Munger said they should have bought more Coke. Once you know it's a good idea you don't need to talk about it. Berkshire's success is measured by how successful they were buying Coke but should be measured by how much more successful they would have been if they bought more. No other management team would be so candid to talk about their errors of omission.

16. CONTRIBUTION TO SEE'S. Berkshire's contribution to See's Candies has been to leave it alone. Often Headquarters screws it up by thinking it knows best. Berkshire doesn't like to micro manage.

17. DIFFICULTY OF ACHIEVING 15% RETURNS IN THE FUTURE. Because of its size Berkshire will have a difficult time achieving market-beating returns in the future. But Mr. Munger said that if you understand the difficulty of something you have a better chance.

18. S&P INDEX ADDITION. Just a matter of time before Berkshire is added and figuring out how to add a stock that has little shareholder turnover.

19. INVESTMENT SUCCESS. To win at investing you need to know and understand many main models of the world e.g. Ponzi scheme. Find an investment manager who is concerned about disappointing you, the customer. Evaluating human beings is important in management and investing.

20. BUSINESS SCHOOLS SHOULD TEACH RETAILING FIRST. Mr. Munger thinks a business education should start first with retailing. When Charlie and Warren walk into a retail business, like a car dealership, they immediately begin to analyze it. Its how they're wired.

21. HOW TO MAKE YOUR LIFE BETTER. Mr. Munger believes in his latticework of models. And he believes that the best thing you can do to make your life better is to master life's models.

22. BUFFETT FOUNDATION. Mr. Munger said that the 5% annual payout required after both Mr. and Mrs. Buffett deaths will not affect the normal operations of Berkshire Hathaway and will be insignificant. No need to worry about future family influences of the Buffett's or Munger's.

23. GREAT STORIES. Mr. Munger told many great stories. A few about Wrigley Chewing Gum and an entertaining one about silver mining companies that made money on silver and by shareholder fraud. Another great story of an investment manager who recently made $100 million for himself by selling his firm but had not served his customers well.

All in all it was one of the best free investment seminars that I have ever attended. Honest. Straightforward. Unrehearsed. Unedited. Nothing to sell. Nothing to buy. Just a great way to size up management.

You can read the transcript but you won't be able to see and hear the tap dancing. This is a great mind available to us all. Next year by popular demand, Mr. Munger plans to expand the meeting.

A SIDE NOTE: Okay I have to admit that I did something after the Wesco Financial annual meeting that may rank higher than learning from one of the best minds in the investment business. In fact this may be the most fun of any business/manufacturing tour I have ever taken and hope to take again. I got a tour of See's Candy factory in Los Angeles.

Jesus Soria, production manager, said there were only a few rules on the chocolate factory tour. One, you can taste anything while inside the factory. Two, you can't take anything with you. Wow. Talk about a kid in a candy store. If you see a noticeable dip in next quarters See's candy profits you can attribute the loss to me.

Being the loyal shareholder I am, I taste tested just about everything. What a tour. And Jesus (a.k.a. Chewy) was able to answer just about every question; including competition, distribution, synergies with other subsidiaries, production before Berkshire, expansion plans, employee relations, spoilage, shrinkage, the manufacturing process, shelf life, and seasonal workloads.

An annual tour of this production facility is a must for any shareholder attending the Wesco annual meeting. An extraordinary investment (and life) seminar followed by a gastronomic delight.

Hope to see you next year.
Willy Wonka

WESCO FINANCIAL CORPORATION

Annual Report 1999

Form 10-K Annual Report 1999

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated ''normal'' net operating income (i.e., before irregularly occurring items shown in the table below) for the calendar year 1999 increased to $45,904,000 ($6.44 per share) from $37,622,000 ($5.28 per share) in the previous year.

Consolidated net income (i.e., after irregularly occurring items shown in the table below) decreased to $54,143,000 ($7.60 per share) from $71,803,000 ($10.08 per share) in the previous year.

Wesco had three major subsidiaries at yearend 1999: (1) Wesco-Financial Insurance Company (''Wes-FIC''), headquartered in Omaha and engaged principally in the reinsurance business, (2) The Kansas Bankers Surety Company (''KBS''), owned by Wes-FIC and specializing in insurance products tailored to midwestern banks, and (3) Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[(1)]:

	Year Ended			
	December 31, 1999		December 31, 1998	
	Amount	Per Wesco Share[(2)]	Amount	Per Wesco Share[(2)]
''Normal'' net operating income of:				
Wes-FIC and KBS insurance businesses	$43,610	$6.12	$34,654	$ 4.87
Precision Steel businesses	2,532	.35	3,154	.44
All other ''normal'' net operating income (loss)[(3)]	(238)	(.03)	(186)	(.03)
	45,904	6.44	37,622	5.28
Realized net securities gains	7,271	1.02	33,609	4.72
Gain on sales of foreclosed properties	968	.14	572	.08
Wesco consolidated net income	$54,143	$7.60	$71,803	$10.08

(1) All figures are net of income taxes.

(2) Per-share data is based on 7,119,807 shares outstanding. Wesco has had no dilutive capital stock equivalents.

(3) After deduction of interest and other corporate expenses, and costs and expenses associated with foreclosed real estate previously charged against Wesco's former Mutual Savings and Loan Association subsidiary. Income was from ownership of the Wesco headquarters office building, primarily leased to outside tenants, interest and dividend income from cash equivalents and marketable securities owned outside the insurance subsidiaries, and, in 1999, the reduction of loss reserves provided in prior years against possible losses on sales of loans and foreclosed real estate.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

Wesco-Financial Insurance Company (''Wes-FIC'')

Wes-FIC's normal net income for 1999 was $43,610,000, versus $34,654,000 for 1998. The figures include $6,415,000 in 1999 and $4,987,000 in 1998 contributed by

The Kansas Bankers Surety Company (''KBS''), owned by Wes-FIC since 1996. KBS is discussed in the section, ''The Kansas Bankers Surety Company,'' below.

At the end of 1999 Wes-FIC retained about $21 million in invested assets, offset by claims reserves, from its former reinsurance arrangement with Fireman's Fund Group. This arrangement was terminated August 31, 1989. However, it will take a long time before all claims are settled, and, meanwhile, Wes-FIC is being helped over many years by proceeds from investing ''float.''

In addition, Wes-FIC has been engaged for several years in super-cat reinsurance, described in great detail in our pre-1999 annual reports, which Wesco shareholders should re-read each year. Wes-FIC also engages in other reinsurance business, including large and small quota share arrangements similar and dissimilar to our previous reinsurance contract with Fireman's Fund Group.

In all recent reinsurance sold by us, other subsidiaries of our 80%-owning parent, Berkshire Hathaway, sold four times as much reinsurance to the same customers on the same terms, except that such subsidiaries usually take from us a 3%-of-premiums ceding commission on premium volume passed through them to Wes-FIC. Excepting this ceding commission, Wes-FIC has virtually no insurance-acquisition or insurance administration costs.

Early in the current year (2000) Wes-FIC made an intracompany loan that funds a large majority of the purchase price of CORT Business Services Corporation, discussed below.

Wes-FIC remains a very strong insurance company, with very low costs, and, one way or another, in the future as in the past, we expect to continue to find and seize at least a few sensible insurance opportunities.

On super-cat reinsurance accepted by Wes-FIC to date (March 3, 2000) there has been no loss whatsoever that we know of, but some ''no-claims'' contingent commissions have been paid to original cessors of business (i.e., cessors not including Berkshire Hathaway). Super-cat underwriting profit of $1.4 million a year, before taxes, benefited earnings in 1999 and 1998. The balance of pre-tax underwriting profit amounted to $3.0 million for 1999 and $1.9 million for 1998. These figures came mostly from favorable revision of loss reserves on the old Fireman's Fund contract.

Wesco shareholders should continue to realize that recent marvelous underwriting results are sure to be followed, sometime, by one or more horrible underwriting losses from super-cat or other insurance written by Wes-FIC.

The Kansas Bankers Surety Company (''KBS'')

KBS, purchased by Wes-FIC in 1996 for approximately $80 million in cash, contributed $6,415,000 to the normal net operating income of the insurance businesses in 1999 and $4,987,000 in 1998, after reductions for goodwill amortization under consolidated accounting convention of $782,000 each year. The results of

KBS have been combined with those of Wes-FIC, and are included in the foregoing table in the category, '' 'normal' net operating income of Wes-FIC and KBS insurance businesses.''

KBS was chartered in 1909 to underwrite deposit insurance for Kansas banks. Its offices are in Topeka, Kansas. Over the years its service has continued to adapt to the changing needs of the banking industry. Today its customer base, consisting mostly of small and medium-sized community banks, is spread throughout 25 mainly midwestern states. In addition to bank deposit guaranty bonds which insure deposits in excess of FDIC coverage, KBS also offers directors and officers indemnity policies, bank employment practices policies, bank annuity and mutual funds indemnity policies and bank insurance agents professional errors and omissions indemnity policies.

A significant change in KBS's operations occurred in 1998 and consisted of a large reduction in insurance premiums ceded to reinsurers. The increased volume of business retained (95% in 1999 and 94% in 1998 compares with 58% in 1997) accompanied slightly higher underwriting income for 1999 after a reduction in the amount for 1998. KBS's combined ratio remained much better than average for insurers, at 59.4% for 1999 and 62.2% for 1998, versus 37.2% for 1997, and we expect volatile but favorable long-term effects from increased insurance retained. Part of KBS's continuing insurance volume is now ceded through reinsurance to other Berkshire subsidiaries under reinsurance arrangements whereunder such other Berkshire subsidiaries take 50% and unrelated reinsurers take the other 50%.

KBS is run by Donald Towle, President, assisted by 15 dedicated officers and employees.

CORT Business Services Corporation (''CORT'')

In February 2000, Wesco purchased 100% of CORT Business Services Corporation (''CORT'') for $384 million in cash. In addition, CORT retains about $45 million of previously existing debt.

CORT is a very long established company that is the country's leader in rentals of furniture that lessees have no intention of buying. In the trade, people call CORT's activity ''rent-to-rent'' to distinguish it from ''lease-to-purchase'' businesses that are, in essence, installment sellers of furniture.

However, just as Hertz, as a rent-to-rent auto lessor in short-term arrangements, must be skilled in selling used cars, CORT must be and is skilled in selling used furniture.

In 1999, CORT had total revenues of $354 million. Of this, $295 million was furniture rental revenue and $59 million was furniture sales revenue. CORT's pre-tax earnings in 1999 were $46 million.

Thus, in essence, Wesco paid $384 million for $46 million in pre-tax earnings. About 60% of the purchase price was attributable to goodwill, an intangible balance sheet asset.

After the transaction, Wesco's consolidated balance sheet will contain about $260 million in goodwill (including $29 million from Wesco's 1996 purchase of Kansas Bankers Surety). On a full year basis, Wesco's future reported earnings will be reduced by about $6 million on account of mostly-non-tax-deductible amortization of goodwill. We do not believe, however, that this accounting deduction reflects any real deterioration in earnings-driving goodwill in place.

More details with respect to the CORT transaction are contained in Note 8 to the accompanying financial statements, and on the last page of this annual report, to which careful attention is directed.

CORT has long been headed by Paul Arnold, age 53, who is a star executive as is convincingly demonstrated by his long record as CEO of CORT. Paul will continue as CEO of CORT, with no interference from Wesco headquarters. We would be crazy to second-guess a man with his record in business. We are absolutely delighted to have Paul and CORT within Wesco and hope to see a considerable expansion of CORT's business and earnings in future years.

Precision Steel

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, contributed $2,532,000 to normal net operating income in 1999, compared with $3,154,000 in 1998. The $622,000 decrease in 1999 net income occurred despite a 2.5% increase in pounds of product sold, and reflects mainly the pounding which competition gave to prices as costs of principal raw materials declined. Fewer dollars of gross profit were available to absorb operating expenses. Precision Steel's operations for 1999 and 1998 also reflect after-tax expenditures of approximately $225,000 and $350,000, respectively, necessitated to upgrade computers and computer systems to ensure that Precision Steel's order-taking and other data processing systems continue to function accurately beyond December 31, 1999.

It is with mixed emotions that we report that David Hillstrom, President and Chief Executive officer of Precision Steel for more than twenty years, retired in the latter part of 1999 and that Terry Piper was elected to replace him. Terry is a very able man and is no stranger to Precision Steel. He joined it as a salesman approximately forty years ago, steadily advanced, and served as President and General Manager of Precision Steel's Precision Brand Products subsidiary for the last thirteen years. Terry now has the responsibility of carrying on the leadership of his predecessor; and, under their combined skills, Precision Steel's businesses in 1999 continued to provide an excellent return on resources employed.

Tag Ends from Savings and Loan Days

All that now remains outside Wes-FIC but within Wesco as a consequence of Wesco's former involvement with Mutual Savings, Wesco's long-held savings and loan subsidiary, is a small real estate subsidiary, MS Property Company, that holds tag ends of assets and liabilities with a net book value of about $15 million. MS Property Company's results of operations, immaterial versus Wesco's present size, are included in the foregoing breakdown of earnings within ''all other 'normal' net operating income (loss).''

Of course, the main tag end from Wesco's savings and loan days is an investment in Freddie Mac common stock, purchased by Mutual Savings for $72 million at a time when Freddie Mac shares could be lawfully owned only by a savings and loan association. The 28,800,000 shares owned by Wes-FIC at yearend 1999 had a market value of $1.4 billion.

All Other ''Normal'' Net Operating Income or Loss

All other ''normal'' net operating income or loss, net of interest paid and general corporate expenses, amounted to after-tax losses of $238,000 in 1999 and $186,000 in 1998. Sources were (1) rents ($2,862,000 gross in 1999) from Wesco's Pasadena office property (leased almost entirely to outsiders, including California Federal Bank as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiaries, less (3) costs and expenses of liquidating tag-end foreclosed real estate. The loss widened in 1999 because fewer dividends were received during the year after forced conversion of preferred stock of Citigroup Inc. (''Citigroup'') into lower-dividend-paying common stock. The ''other 'normal' net operating income or loss'' figures for 1999 and 1998 also include intercompany charges for interest expense ($353,000 and $102,000 after taxes, respectively) on borrowings from Wes-FIC. This intercompany interest expense does not affect Wesco's consolidated net income inasmuch as the same amount is included as interest income in Wes-FIC's ''normal'' net operating income. ''Other 'normal' net operating income or loss'' benefited in 1999 by about $800,000 caused by reversals of reserves for possible losses on sales of loans and tag-end real estate, expensed in prior years.

Net Securities Gains and Losses

Wesco's earnings contained securities gains of $7,271,000, after income taxes, for 1999, versus $33,609,000, after taxes, for 1998.

Although the realized gains materially impacted Wesco's reported earnings for each year, *they had a very minor impact on Wesco's shareholders' equity*. Inasmuch as the greater portion of each year's realized gains had previously been reflected in the unrealized gain component of Wesco's shareholders' equity, those amounts were merely switched from unrealized gains to retained earnings, another component of shareholders' equity.

Consolidated Balance Sheet and Related Discussion

As indicated in the accompanying financial statements, Wesco's net worth decreased, as accountants compute it under their conventions, to $1.90 billion ($266 per Wesco share) at yearend 1999 from $2.22 billion ($312 per Wesco share) at yearend 1998.

The $328.4 million decrease in reported net worth in 1999 was the result of (1) $54.1 million from 1999 net income; less (2) a $374.1 million decrease in the market value of investments after provision for future taxes on capital gains; and (2) $8.4 million in dividends paid.

The foregoing $266-per-share book value approximates liquidation value assuming that all Wesco's non-security assets would liquidate, after taxes, at book value. Probably, this assumption is too conservative. But our computation of liquidation value is unlikely to be too low by more than two or three dollars per Wesco share, because (1) the liquidation value of Wesco's consolidated real estate holdings (where interesting potential now lies almost entirely in Wesco's equity in its office property in Pasadena containing only 125,000 net rentable square feet), and (2) unrealized appreciation in other assets (primarily Precision Steel) cannot be large enough, in relation to Wesco's overall size, to change very much the overall computation of after-tax liquidating value.

Of course, so long as Wesco does not liquidate, and does not sell any appreciated assets, it has, in effect, an interest-free ''loan'' from the government equal to its deferred income taxes on the unrealized gains, subtracted in determining its net worth. This interest-free ''loan'' from the government is at this moment working for Wesco shareholders and amounted to about $99 per Wesco share at yearend 1999.

However, some day, perhaps soon, major parts of the interest-free ''loan'' must be paid as assets are sold. Therefore, Wesco's shareholders have no perpetual advantage creating value for them of $99 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than $99 per Wesco share. In the writer's judgment, the value of Wesco's advantage from its temporary, interest-free ''loan'' was probably about $20 per Wesco share at yearend 1999.

After the value of the advantage inhering in the interest-free ''loan'' is estimated, a reasonable approximation can be made of Wesco's intrinsic value per share. This approximation is made by simply adding (1) the value of the advantage from the interest-free ''loan'' per Wesco share and (2) liquidating value per Wesco share. Others may think differently, but the foregoing approach seems reasonable to the writer as a way of estimating intrinsic value per Wesco share.

Thus, if the value of the advantage from the interest-free tax-deferral ''loan'' was $20 per Wesco share at yearend 1999, and after-tax liquidating value was then about $266 per share (figures that seem rational to the writer), Wesco's intrinsic value per share would become about $286 per share at yearend 1999, down 16% from intrinsic

value as guessed in a similar calculation at the end of 1998. And, finally, this reasonable-to-this-writer, $286-per-share figure for intrinsic per share value of Wesco stock should be compared with the $245 per share price at which Wesco stock was selling on December 31, 1999. This comparison indicates that Wesco stock was then selling about 14% below intrinsic value.

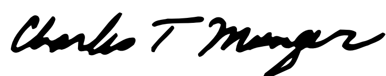
Wesco's investment portfolio suffered more than its commensurate share of decline in market value in 1999. Last year, we said ''as Wesco's unrealized appreciation has continued to grow in frothy markets for securities, it should be remembered that it is subject to market fluctuation, possibly dramatic on the downside, with no guaranty as to its ultimate full realization.'' The stock of several of our largest investees lagged the market in 1999 by a large margin. It's no sure thing that the value of our marketable securities will quickly recover. Unrealized after-tax appreciation represented 69% of Wesco's shareholders' equity at 1999 yearend, versus 76% and 73% one and two years earlier.

Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway. Moreover, the quality disparity in book value's intrinsic merits has, in recent years, been widening in favor of Berkshire Hathaway.

All that said, we make no attempt to appraise relative attractiveness for investment of Wesco versus Berkshire Hathaway stock at present stock-market quotations.

The Board of Directors recently increased Wesco's regular dividend from 29½ cents per share to 30½ cents per share, payable March 8, 2000, to shareholders of record as of the close of business on February 9, 2000.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.



Charles T. Munger
Chairman of the Board

March 3, 2000

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Outstanding Investor Digest

THE FOLLOWING IS A SPECIAL REPRINT FOR BERKSHIRE SHAREHOLDERS
WITH THE COMPLIMENTS OF BERKSHIRE HATHAWAY

PERSPECTIVES AND ACTIVITIES OF THE NATION'S MOST SUCCESSFUL MONEY MANAGERS.

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OID MAILBAG:
FPA CAPITAL FUND'S BOB RODRIGUEZ
"MANY VALUE STOCKS ARE BEING NEGLECTED — AN OPPORTUNITY WE WISH TO SHARE WITH INVESTORS."

After closing FPA Capital Fund to new investors in 1995, Bob Rodriguez said two criteria would have to be met before he would reopen it: (1) There would have to be a plethora of investment opportunties. And (2) there would have be very little interest in value investing. In his latest letter to shareholders, he says both requirements have been met.

(continued on page 2)

OAKMARK FUNDS'
BILL NYGREN & HENRY BERGHOEF
"EVERYONE'S BECOME A MOMENTUM INVESTOR — A TREMENDOUS OPPORTUNITY FOR VALUE INVESTORS"

Bill Nygren started managing Oakmark Select Fund in November of 1996. He told his partners at Harris Associates that his goal was to run a concentrated value portfolio and achieve an excellent track record over time. He told them that if the firm's past track record was any indication, somewhere in the first five years, there'd probably be an exceptional year: hopefully, there wouldn't be a horrible year; and the rest would probably be mediocre.

(continued on page 4)

BERKSHIRE HATHAWAY'S WARREN BUFFETT &
WESCO FINANCIAL'S CHARLIE MUNGER
"WE USE THE PHRASE 'WRETCHED EXCESS' BECAUSE THERE ARE WRETCHED CONSEQUENCES."

As we've said before, introducing Berkshire Hathaway's Warren Buffett and Charlie Munger in the pages of *OID* is akin to introducing the Pope at the Vatican — unnecessary at best. But $10,000 invested in Buffett Partnership in 1956 and reinvested in the stock of Berkshire Hathaway at the partnership's termination in 1969 would today be worth more than $270 million — *after all taxes, fees and expenses.*

Incredibly, even those figures understate Buffett's feat

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THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
"USG'S FINANCIAL STRENGTH IS CLEAR. WE'RE FOCUSING ON ITS LIABILITIES."

If anyone is more qualified to assess a company in the midst of legal uncertainty than Marty Whitman, we don't know who it would be. Besides knocking the cover off the ball year after year at Third Avenue Value Fund and being a recognized expert in the field of bankruptcy, he's invested in distressed securities for more than 40 years and even taught graduate level courses on the subject for most of that time.

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WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from page 1)

— because, believe it or not, before fees, but after all taxes, that $10,000 would have grown to more like *$500* million.

Of course, the manner in which they've achieved those returns is no less remarkable. (However, we won't utilize scarce space to re-tell you about it here.)...

The following excerpt was the Wesco Financial segment of this edition's 27-page feature on the annual meetings of Berkshire Hathaway and Wesco.

We're very pleased to bring you excerpts ... from Munger's answers to questions from shareholders at Wesco Financial's meeting. And as always, we highly recommend a careful reading (re-reading, etc.).

WE'VE VERY RARELY HAD TO REMOVE ANYONE. AND IT'S NOT BECAUSE WE'RE SOFT OR FOOLISH.

We're the least "people-removing place" I've ever seen.

Shareholder: One of your most important jobs is to judge people — and you guys have done a fabulous job over the years. But occasionally, you decide that somebody doesn't fit. And I know that every situation is idiosyncratic and specific to that set of facts. But have you learned anything over the years that helps you decide whether it's the wrong person as opposed to someone running into bad luck or making a single bad decision?

Charlie Munger: It's *amazing* how few times over the decades we've had to remove a person. Compared to any other company I know, we're the "least people-removing" place I've ever seen. And I don't think that's because we're soft or foolish. I think it's because we're either wiser or luckier in the people that come to power in the first place.

We all tend to be too slow in doing the obvious people-wise.

Munger: However, *anybody* who makes a lot of personnel decisions makes mistakes that have to be corrected. And if you ask 100 intelligent executives looking back on their careers what their worst mistakes were, a high percentage of them will say, "I was way too slow to make some personnel change after it became obvious."

I'd guess that if you were to ask Deloitte & Touche what the big mistakes were that they made, they would say, "I was way too slow to cashier some client or partner." The human condition is such that we all tend to be too slow in doing the obvious.

But we've tended to be right about people time after time.

Munger: But our record is *fabulous* on that. It may be partly because we're so old-fashioned. Whatever it is, it's been working very well.

When Cort Business Systems came into Wesco, Warren said, "You're going to love Paul." And he was right. Paul has been working at Cort since he was in law school and he's been running it for many years. He really understands it. And he *likes* it. And he's *good* at it. He wouldn't have fabulous numbers from what looks like a mundane business without very excellent management.

We're guessing when a person like Paul Arnold comes aboard that he'll be here long after we're gone. And so far, we've been right on that kind of thing time after time.

The guy who ran Precision Steel for us finally retired after 50-odd years with the business. And he's been succeeded by a veteran of a mere *40* years or thereabouts.

THERE ARE CERTAIN VIRTUES IN OUR SUBSIDIARIES, BUT WE DIDN'T CREATE THEM. THEY WERE THERE.

We didn't create our subsidiaries' virtues. They were there.

Alice Schroeder: I've spent a lot of time in the last year travelling around meeting the managers of the different Berkshire operations. And Berkshire's portrayed as not having a unified culture, a centralized management or anything that really characterizes it — that the different operations are run completely individualistically.

Yet one of the things that struck me — one of the first things I noticed — is that there is, in fact, an *extremely* unified culture. The different companies have things in common. If I had to boil it down, I'd say every one of these people knows their own circle of competence with great intensity, has *no* desire to venture beyond it and really understands the promise they're making to their customers and that keeping that promise is the single most important thing.

Are all these companies in that identical state when you buy them or is some of this instilled afterwards?

Munger: You're right. Certain common virtues *are* observed in the Berkshire subsidiaries. That's because we *love* those virtues and we tend to select companies that display those virtues. But we haven't created the virtues. They were there in the culture before we ever came along. What we do is not screw it up.

That's not to say their virtues haven't been reinforced....

Munger: I do think that when those managers come to the annual meeting or bump into one another at other times and mix socially with other managers running other businesses and they find people very much like themselves with very unusual success stories, there's reinforcement — to use the psychological term — of the existing strength of the Berkshire subsidiaries' individualistic cultures.

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WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

I hope there will be some spread of desirable practice, say, in furniture retailing where we've got different practices that work in different places. For instance, in Utah, they've been way better at building a wonderful credit business than, say, we have in Omaha. Yet in Omaha, we've been way better at doing certain things than they have in Utah. And there are some distinct differences. For example, in furniture retailing, some subsidiaries are way more promotional than others. Well, we'd hope that we'd each learn from one another.

But we don't *force* those changes on subsidiaries. That's where we're different from other people. And we don't try and have a bunch of culture vultures at headquarters that are haranguing the troops to be more like us. We get a common culture because we've *selected* for it....

WE HAVE WAY LESS RISK OF A RUINOUS SURPRISE THAN ALMOST ANY INSURANCE COMPANY AROUND.

Do we think about catastrophe risk? Only with each breath.

Shareholder: A bunch of theologians and I were having lunch before the meeting and we were considering the risk of the super-cat business on Berkshire Hathaway's balance sheet. Capitalization in relation to premiums seems extraordinarily low. But given an enormous catastrophe and all of the super-cat hitting their top lines, what is the real ratio of potential loss to capital? Have you ever done that on the back of the envelope?

Munger: Well, I'd say it's done every *time* at the top on the back of an envelope. No important policy is written without the concurrence of Ajit Jain and Warren. So you've got two minds that think in terms of maximum loss the way you breathe — namely, automatically.

We don't *write* contracts where there's no upper limit. We do write *little* contracts like on an individual auto [where] we don't pay much attention to limits. However, for big super-cat exposures, every policy has a limit of maximum exposure.

Now, sometimes there's an automatic reinstatement... — so that the worst thing that could really happen would be a big earthquake followed by a big earthquake. But to me, it's inconceivable that we would lose 6% or 7% of the net worth of the company after taxes on one event.

(continued in next column)

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We have way less catastrophe risk than almost anyone.

Munger: We *like* writing [contracts] where we take risks on that scale. The big risks of super-catastrophe, by and large, aren't in super-cat policies. They're in [the companies that] write ordinary policies against storms or something who haven't laid off the risk in any way by effective reinsurance. If big enough storms came through developed-enough swaths of the country, some insurers could suffer losses way beyond their total capital.

Roughly, that happened to 20th Century right here in California. That earthquake basically took 100% of their capital. And it happened because they had a lot of little policies concentrated [geographically] — and an earthquake, of course, had concentrated effects.

No, I would say that we have *way* less chance of a ruinous surprise than almost any insurance company that you could name. On the other hand, we have a way *greater* chance than most people of having an occasional year where we take a whack like 6% of capital after taxes.

We're buying less reinsurance and selling more everywhere.

Shareholder: ...If I read the annual report right, Wesco lays off some of the risk that Kansas Banker's Surety takes on to others. Maybe it's to Berkshire. Why doesn't Wesco carry the whole thing?

Munger: Well, that's a very intelligent question. We do carry miles more of the risks at Kansas Banker's Surety than the company carried for itself without reinsurance before we bought it. But we haven't gone to zero reinsurance — we've gone to immensely *reduced* reinsurance. But you raise a very good question.

Shareholder: Will you carry the whole risk at some time?

Munger: That's certainly conceivable. We tend to do less reinsurance everywhere where we're the purchaser and more where we're the reinsurer.

We can handle lumpy results.

Shareholder: It seems that Wesco is getting bits and pieces of reinsurance. Do you worry about the lack of diversification and whether your results will be quite different from the parent company when you're not getting a pro-rata share of everything?

Munger: ...The nature of the reinsurance business of Wesco is odd bits and pieces, sometimes big chunks. And am I worried about the fact that that's unconventional and that it will cause lumpy results? No. I'm not worried about it causing lumpy results. We're rich enough that we can handle lumpy results.

After all, we've had lumpy results on the *good* side for a long, long time. And we're so rich that we can handle an occasional lumpy result on the *bad* side. And we think it'll work out OK over a long time.

And that's not a *defect*. It's an *advantage*.

Munger: That is one of our *advantages* as an insurer.

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WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

We don't give a damn about the results being lumpy — whereas everybody else is trying to please Wall Street by having smooth results. And that is not a small advantage.

So what your question may cause some people to view as a *defect*, I think of as the shining face of an advantage.

Low premiums to surplus = Greater investment flexibility.

Shareholder: I believe that Wesco writes at about 10% of its surplus. I just wondered if you could tell us how much Berkshire writes as a percentage of its surplus?

Munger: Both Wesco and Berkshire write amazingly low amounts of insurance in relation to surplus. And that practice gives us way more investment flexibility than companies that write a lot of volume in relation to surplus — and we *like* it that way. That's part of the reason.

The other part of it is that we just don't find enough opportunities to write insurance to use the capacity that we have. We would *cheerfully* write a lot more insurance than we do if we could conveniently find policies that were attractive to us....

Decline in GEICO's float growth not necessarily a negative.

Shareholder: The ratio of float to premium growth at GEICO has declined steadily since Berkshire acquired it — so that the growth in float hasn't matched the growth in premiums. Can you tell us whether you think that ratio will bottom out at some point and float will then grow at a faster rate or give us your thoughts about that?

Munger: Here, I can give you an answer in which I have total confidence. I didn't know that it was going down. And now that I do, I could only guess why it's happened.

Here in California, the ratio of float went down because we squeezed a lot more fraud out of the auto accident settlement business. It was fraud that increased that float. If every little fender-bender is turned into phony chiropractic testimony, phony economic testimony, etc., etc., etc., float goes up.

In California, they changed the laws to some extent and the defense practices were changed to some extent. As a result, an enormous amount of fraud was squeezed out of the auto liability business in California. And that reduced the ratio you're talking about.

However, whether or not that's been the case at GEICO, I'm ashamed to say I do not know....

ACCOUNTING FOR DERIVATIVES IS A *DISGRACE*,
BUT GEN RE AND BERKSHIRE WILL DO IT RIGHT.

Accounting for derivatives is a *disgrace*....

Shareholder: Can you talk a little bit about Berkshire's substantially increased use of leverage through its General Re derivatives operation? I think it's increased about 50% from the time it was purchased. Is that a proper use of capital — to invest over $2 billion [in derivatives]? And isn't the downside risk much greater than the upside potential?

Munger: I have not followed in detail the nature of the General Re derivatives business. I *did* follow a very, very similar business at Salomon very closely over many years when I was a director and on the audit committee.

And I hate with a *passion* Generally Accepted Accounting Principles as applied to derivatives — in particular, interest rate swaps. The accountants sold out. J.P. Morgan was the last holdout among the reputable banks. But it sold out to a type of accounting that front-ends into income revenues that should not be recognized as income until very much later. So that is my opinion. I regard it as a *disgrace*.

And it's very stupid to have disgraceful accounting and then reward all the people doing the trading based on profits which are displayed in that disgraceful accounting. So I have that general feeling on derivatives.

But General Re does it better than most, if not all....

Munger: I am sure that General Re has a more conservative operation and better accounting than most, if not all, of the other players in the field. It's a naturally risk-averse place. It may have had some misfortune — even a mistake — lately. But basically, it's a very intelligent place with a very good culture. And its business instincts are right.

I don't like the basic business of being a derivatives dealer.

Munger: However, I do not like derivatives trading in interest rate swaps as the world has developed. It's a field with shoddy accounting and other irresponsible aspects.

Bob Denham is here. He was CEO of Salomon and sat sadly scratching his head through some of those hard days. I don't think I'll put Bob on the spot on that one with so many old colleagues and what have you. But I'm so old, I'm willing to just call 'em the way I see 'em.... The basic business of being a derivatives dealer with the kind of accounting that we now have, I don't like.

But it's quite possible, even necessary, to use derivatives.

Munger: Still, I never wanted its total elimination from Salomon — because I thought we *had* to be in it. And it may well be that at some level a little of it has to exist in General Re or even at Berkshire. And I never minded the derivatives trades that were done by the Meriwether group at Salomon. What I minded was the derivatives business conducted on a market-making business by *other* groups within Salomon.

I think it's quite possible to *use* the derivatives market. Indeed, Berkshire's quite capable of doing that in the future. But basically, I think there's a lot that's irresponsible in the derivatives business. And General Re has already

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WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

announced that they plan to, one way or another, do *less* of it....

THERE'S PRACTICALLY NOTHING IN ACCOUNTING TO KEEP THE SKILLED FROM SHUCKING THE SUCKER.

Accounting abuse is regrettable now and will be *more* so....

Shareholder: My question is about accounting ... specifically the recent proliferation of accounting fraud as well as abuse of accepted GAAP accounting and the implications for an outside passive minority investor in public securities evaluating businesses even when one finds a superior business at an attractive price. Could you please comment on that as it relates to its implications for the markets and how one might go about correcting it?

Munger: Where so much money turns on numbers that happen to be reported, the human temptation to manipulate the numbers is bound to be pretty substantial. And then, when everybody's doing it, you get what I call "Serpico Effects" — you know, everybody else is doing it and you're a sucker if you don't go along and so on and so on. So I do think we get tons of promotional accounting, *particularly* in a period like this — which is regrettable now and will look even *more* regrettable when we look back on it a few years hence.

Defrauding suckers is hardly a new activity for the species.

Munger: I think it's *always* been thus. You can see what human nature will do unobstructed if you go back to the days of the early Irish ruffians who ran the Comstock Lode. Those guys were not satisfied with having the heart of the Comstock Lode where they could mine silver more efficiently than it had ever been mined before in the history of the world. After all, you can only make so much money digging out all the silver and turning it into currency.

So they decided since they controlled the companies, they would turn a *one*-handled pump for making money into a *two*-handled pump. Mining companies in those days declared monthly dividends. So they'd run the dividends way up, put out a lot of wonderful rumors — and then they'd sell short heavily. Then they'd fill the mine with water, cut the dividends to zero and buy the shares back. And you could do that over and over again. They turned a mine into something that would make money in two ways — mining silver and defrauding suckers.

It's not so *crude* today, but it's still being done in *spades*.

Munger: If it were *legal*, it would be done enormously to this very day. People get pretty close to it in some ways by crowding in to take advantage of unsound accounting conventions. The standard way of doing it today is not so crude as the one devised by Fair, Flood, Mackay & O'Brien — the gentlemen who figured out the two-handled pump system for handling the Comstock Lode.

Today, it's chain letter mechanics that people use to shuck the suckers. And since they're mixing the mechanics of a chain letter with legitimate activities like venture capital, improving commerce and what have you, it gets respectable. That's what caused great hostility from my wife when I said, "When you mix turds with raisins, they're still turds." I think we're mixing those respectable activities with *un*-respectable activities.

And that's being done in *spades* in the current era. There's practically *nothing* in accounting that is carefully designed to limit what some sophisticated entrepreneur can do with chain letter principles skillfully worked into a legitimate enterprise.

AND DARWIN DOESN'T JUST APPLY TO BIOLOGY. EVOLUTION IS AT WORK IN BUSINESS, TOO.

The New New Thing describes an appalling culture.

Shareholder: Have you read *The New New Thing* by Michael Lewis? If you have, may I ask your opinion of it?

Munger: Yes, I did. And I found it interesting enough so I didn't put it down until I'd finished. In some respects, it describes an appalling culture. It's had some creativity and made some large contribution to the wider civilization. But some of what's developed in that culture is not pretty.

In England, in the days of the asset-strippers — remember Slater? — one of the prime ministers called him "the unacceptable face of capitalism". And I would say that there were things described in *The New New Thing* that come pretty close to the unacceptable face of capitalism....

It's hard to isolate the five most valuable books I've read.

Shareholder: This year, [at Berkshire Hathaway's annual meeting,] you did not recommend any books. Could you name three to five important books you've read in your life that you might suggest to people who are interested in your field?

Munger: Well, I have trouble doing that because I've *blended* so many books in my own mind. If you have a very interdisciplinary mindset — which I've had for decades — you're just going through books like a scavenger slotting things out of the book into your own internal system. Therefore, you can't point to one book and say, "There is the source of all Truth" the way that the people at the Fuller Theological Seminary do right across the street.

But *The Selfish Gene* is one fabulous book.

Munger: I have had *enormous* pleasure at picking up this modern Darwinian synthesis — you know, Dawkins' *The Selfish Gene*. If you've never been introduced to that book and the way of thinking that's contained in that book — if you have any intellectual curiosity about the human condition — that is one fabulous book. The truth of the

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WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

matter is without that insight, the basic Dawkins insight, you don't properly understand one of the most important theories ever found.

And by the way, he didn't *invent* the insight. He just popularized it better than anyone else has ever popularized a difficult insight.

But I would say that that is one fabulous book. So if any of you haven't ever read Dawkins' *The Selfish Gene*... That is one wonderful book.

Everything isn't invented. Sometimes it just evolves....

Shareholder: Are there lessons from the field of evolution that we can apply to evaluating businesses and industries? In other words, are there parallels in biology and business in terms of the functions and structures and the performance and the development of things?

Munger: Well, the answer to that is, "*Yes.*" All *kinds* of things that work in business have been discovered by what I call "*practice* evolution". And just as evolution has gradually developed the eyes and wings and claws and behavior patterns that work so well to feed the animal, human enterprises have developed behavior patterns winnowed by their successes and failures.

So a lot of what you see that works like crazy, nobody thought it through *ab initio* the way that you would derive some theorem of geometry from axioms. They just blundered through a lot of things, repeated what worked and avoided what didn't. And in time, the result was a very elaborate practice evolution.

Darwin in business — the origin of ~~species~~ businesses.

Munger: Take something like Cort which has been in business for such a very long period. It has a lot of practice evolution in its personnel system and its practices of a million different things. When you evaluate businesses as a common stock investor, you're betting to some extent on the outcomes of practice evolution. And some people have developed better systems.

Take a mundane business like the car rental business — the equivalent of what Cort is doing with furniture — the short-term rental of automobiles: Both Hertz and Enterprise have through practice evolution created personnel systems, leasing systems, location systems and reward systems that work very well for them and that are different. It's very much like biology. In other words, Enterprise Rent-A-Car and Hertz are like two different species in ecological niches that are close together. Through practice evolution, they're just like two different butterflies. And each system *works*.

So yes, I think a lot of money can be made by common stock investors by identifying the outcome of practice evolution which really works.

There wouldn't be Tupperware parties if they didn't *work*....

Munger: One of the most extreme examples in modern capitalistic history was Tupperware. It developed what I regard as a corrupt system of psychological manipulation in order to sell a better class of plastic dishes. Well, when Justin Dart brought that to his board of directors for purchase, a couple of directors *resigned*. They thought it was so schlock, they didn't want to be identified with it.

But Justin Dart figured, "Well, nobody would have invented all that crazy shouting of Tupperware and bugging one friend to entertain other friends etc., etc. unless the practice evolution *worked*."

And Tupperware had enormous — what they call in show business — "legs". *Billions* of dollars were made out of Tupperware parties. And it went on for *decades*, although I think it's groaning in the traces now — as it probably should.

But my point is that somebody who *never* would have invented that system, like Justin Dart, saw it was working. And even though it came out of practice evolution, he predicted that it would *keep* working and the fact that it looked so *schlock* would keep a lot of other people *out* of it. At any rate, his decision made him a lot of money.

A *lot* of money can be made by thinking biologically.

Munger: So I do think biological reasoning actually can help you in investing because I think you will frequently find the outcomes of practice evolution in companies that will point to money-making opportunities that you can't recognize by deriving them from fundamental principles or something like that. Therefore, you've got to think *biologically* — as I think Justin Dart did with respect to Tupperware. I think a *lot* of money can be made that way.

We wouldn't have bought Cort Systems if we didn't like the culture that has evolved there — which, again, is practice evolution.

In most messy human problems, you need *all* the models.

Shareholder: You've talked about carrying a lot of models to improve your life. With your life experience and your knowledge about notions and models, do you have some special kind of general framework for reasoning when you apply those notions and models so that there are some generic questions you ask yourself when you approach different types of issues?

Munger: Well, that's a good question. My notion is so simple that I wonder that everybody doesn't immediately adopt it. I think you have to know the big ideas in all the big disciplines. Then, in most messy human problems, you have to be able to use *all* the big ideas and not just a few of them.

What happens is that people are trained in economics or engineering or marketing or investment management or something else. So they learn a few models and then they run around trying to solve all their problems with a limited number of models. And they don't really understand how their models intermix with other people's models.

So my system, such as it is, is just to learn all of the

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WESCO FINANCIAL'S
CHARLIE MUNGER
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big models and use them *routinely* instead of just the models in which you happen to have the training. I've always loved that old saying, "To a man with a hammer, every problem will tend to look pretty much like a nail." That is a very dumb way of handling problems.

The core of EVA makes sense, but it wouldn't sell that way.

Shareholder: In Stewart's book, *The Quest for Value*, where he talks about Economic Value Added, he references Mr. Buffett in terms of the creation of shareholder value. I just wondered to what extent you and Mr. Buffett embrace the EVA principle and if you use that in your analysis?

Munger: Well, EVA, of course, is very popular because at least it talks about how you get a high return on capital and points out that shareholders are enormously benefited if you manage to get a high return on capital and if you can reinvest at that high return for a very long time.

But if you stated it the way that I've just stated it, you couldn't sell any books.

I don't think it's an admirable human system.

Munger: So you have to dress up the elementary idea with a lot of twaddle, copyright the twaddle and sell it to various people at high prices per hour — making it *worse* by introducing fuzzy concepts that don't really *work*, like a cost of capital concept that makes no true economic sense.

I don't want to talk any more about it. You can see that I... I think it's succeeding because there's some underlying truth that it is consonant with. But I don't think that it's an admirable human system. In its totality — what should I say? — it's like psychoanalysis.

WHAT WE'RE DOING SHOULD SPREAD — BUT WHAT'S SPREADING IS SOMETHING ELSE.

Why aren't we copied more? Partly because we're different.

Shareholder: I'd like to pick up on your thread with regard to economics and psychology. Why do you find that no one else seems to be trying to emulate Berkshire today? You have fund managers who run funds and people who run companies, but Berkshire seems to be rather unique. Why isn't anybody else trying this formula?

Munger: Well, I think that's a very good question — and, of course, we've asked that of ourselves. Look at how it's worked for us and the obvious fun we're both having doing it. Look at the fun our managers are having running their businesses. And look at the fun, by and large, that the shareholders are having which you can see at the annual meetings — even at crazy gatherings like this one. Why don't more people copy it? I think more *should*.

I don't think what we're doing is that difficult. I think it *looks* difficult from the outside — partly because it's unconventional. I think the unconventionality of it makes it get rejected. It isn't the way things are normally done. We don't have all these budgets, goals, quarterly reviews and all *kinds* of things in terms of dealing with subsidiaries that are standard in American management. We don't have personnel systems that are standard. And our investments are way more concentrated than is conventional in portfolio management.

Everything we do just strikes me as simplicity itself and to make nothing but sense. Yet it is very little copied.

People do copy us some — sort of....

Munger: It *does* get copied some. People invent something — or at least they invent a new *name* for it. They call it "Focus Investing." And they say, "We're going to be like Berkshire. We're going to have 10 securities instead of 40" — or 10 instead of 400 or whatever. I think there is more of that. I think so-called "Focus Investing" is growing somewhat, but only slightly.

What's *really* growing is exactly what I criticized in my speech to the Foundation Financial Officers [Group] — just unlimited consultants on allocation strategies and consultants on the monitoring of other consultants. *That's* what's growing. It's being *taught* in the business schools.

I was with Jack McDonald the other day at Berkshire's annual meeting. He teaches sort of a Berkshire mindset in terms of portfolio management at Stanford Business School. And I'll tell you what *he* feels. He feels lonely like the Maytag repairman. And I'm afraid that that's just the way it is.

We know why our compensation system isn't copied.

Munger: The world's *always* had crazy conventions. I was in Army ROTC for six years in high school and college. And that was a limited culture with certain standard constructs. It did not have a lot of new ideas. And I think there's a lot of that kind of ROTC thinking at very high falutin' places where people have Ph.D.'s and other advanced degrees. That's just the human condition.

But I don't know *why* our example isn't copied more. You'd think having overhead as low as we have it would attract people. Of course, part of how we *keep* it so low is not assaulting corporate compensation systems *ourselves*. And Berkshire's system for paying its top executives is a nonstarter at most places.

I'm not answering questions at this meeting for the money.

Shareholder: Which question should I ask of you today to highlight any specific area that might be fascinating to you?

Munger: I'm more fascinated with effective rationality as a lifelong quest than I am with any detailed activity like golf, accounting, bridge or what have you. And I'm quite confident my mindset will spread because it *works* better. In other words, a more basic, multidisciplinary approach to messy human problem-solving will spread. It *is* spreading.

And to the extent that I can contribute a tiny mite to

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WESCO FINANCIAL'S
CHARLIE MUNGER
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that by answering questions here for a long time, that's why I'm doing it. It isn't that I like being a paid entertainer — or, even worse, an *unpaid* entertainer.

There are lessons in this little meeting for a reason....

Munger: I do think these ideas that come out in response to your questions either *are* or *should* be of utility generally — and in activities far removed from investing in common stocks. I'm talking about *lifes*manship.

I think Berkshire is about lifesmanship. I think the lives of the people that run the Furniture Mart or the two subsidiaries we have here in Wesco are good lives. I think the people around headquarters at Wesco have had pretty good lives even though they have had a basic business shot out from under them. And I'm talking about the savings and loan business.

So to the extent there are lessons in this little meeting, all I can say is, it's *intentional.*

IS COCA-COLA EXPENSIVE? SURE.
BUT THEN AGAIN, IT *SHOULD* BE.

If I'm right, if you own Coke long enough, you'll do all right.

Shareholder: What long-term growth rate in both unit case volume and EPS growth do you think that Coke will be able to achieve? Recently, *Beverage Digest*, a respected trade magazine, polled a number of bottlers who believe Coke cannot achieve its current unit case growth goals of 5-6% in the U.S. and 7-8% in the rest of the world without a price war.

And in my humble assessment, the bottlers have a little more credibility than Coke's management team at the moment in terms of their assessment of the business. So could you help me with that?...

Munger: Well, I don't think my view as to the exact probable percentages for future growth at Coke should get any special weight. I would be willing to bet a lot of money — in fact, you can say that indirectly I *am* betting a lot of money — that over the next 20 or 30 years, Coke will be selling materially more soft drink and other drink products. And I think they'll also be able to raise prices moderately during the same period and, if anything, increase margins.

Now if I'm right in that long-term view, if you own Coke and hold it long enough, you'll do all right. However, I don't think I want to get into arguing with the experts about the correct target for Coke.

Some believe in setting unreasonably high goals....

Munger: There are two lines of thought.... A whole bunch of management gurus say you need B-HAGs — bold, hairy, audacious goals. That's a technique of management — to give the troops a goal that looks unattainable and flog them heavily. And according to that line of thought, you will do better chasing a B-HAG than you will a reasonable objective.

And there's some *logic* in that — because if you tell your kid A-minuses are fine and he likes partying around the beer keg and can easily get A-minuses, you may *well* get a lower result than you would if you gave him a different goal.

[Editor's note: That reminds us of John Templeton's experience as a youth. After young Templeton brought home straight A's on one of his first report cards, his father, Harvey Templeton, decided that he would reinforce his son's drive for excellence by wagering him a bale of cotton that he could not achieve straight A's on his subsequent report cards. The result? Templeton earned straight A's in each and every grading period during elementary school, junior high school and high school (and 22 bales of cotton).]

Unfortunately, unreasonably high goals cause cheating....

Munger: Then there's another group that says that if you make the goals unreasonable enough, human nature being what it is, people will cheat. And you see that in the public schools — where they say you've got to have the reading scores better so we're going to pay the teachers based on the reading scores getting better. So the teachers start helping students cheat to pass the reading tests. So human nature being what it is, if the goals are unreasonable enough, you will cause some cheating in your corporation — or even within your top management.

Each organization has to find its own way.

Munger: I can't *solve* that problem. There are two factors that are at war. You don't want the cheating — which is bad long term and bad for the people who are doing the cheating. However, you *do* want to maximize the real performance. And the two techniques are at *war*.

What people generally do is give people the unreasonable goal and tell 'em, "You can't cheat." That's basically the goal at General Electric. They say, "We don't want any excuses.... But don't cheat.... If you can't handle those two messages, why, perhaps you'd be happier flourishing somewhere else." That is the American system in many places.

I've got no answer to that tension. Low goals do cause lower performance and high goals increase the percentage of cheating. Each organization has to find its own way.

Is Coke expensive? Yes. But it *should* be....

Shareholder: I understand your point — that stretch goals have certainly worked out great at General Electric.

If you could then help me think about my intrinsic value calculation. When I play around with the numbers and I take the highest earnings that Coke's had over the last several years and try to grow that out at fairly aggressive numbers — perhaps 9% for 10 years, 7% for 10 years after that, etc., permanently settling out at 3% or 4%

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WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

— and then use an 8% discount rate, I still have a hard time seeing how the stock is anything but slightly overpriced. What might I be missing?

Munger: Well, you're pointing out a basic element of human securities valuation: If growth is *sure* enough, at practically any slight advantage over standard returns — say, interest rates — and if you project it far enough, the present values get very *high*. So when you get stocks like Coke where a lot of people have a lot of confidence that if they're coloring and flavoring 2% of the world's water now and it'll be 4% 20 years from now or something like that and they'll be charging higher prices, then people start giving it these higher valuations based on what you might consider a moderate advantage projected a long time.

But moderate advantages projected ahead a long time cause very high real values now. That's just the way the math works out. So what you're seeing in Coke is a residual prediction in spite of the stumbles of recent years that the underlying strength is still there — and that if you blank out these blips up and down, 20 years from now they'll be coloring and flavoring a lot more water and earning more per serving, which is the way that I tend to think personally.

SOMETIMES I'M IN THE DARK INVESTMENT-WISE,
BUT I KNOW WHAT WE'RE DOING WITH NET-JETS.

We don't even *look* at what Lou Simpson's doing.

Shareholder: You guys took two positions — one in Great Lakes Chemical and the other in the furniture area. Could you comment on both industries?

Munger: Well, I don't want to comment on the chemical industry. And by the way, when you say "you"... Frequently Lou Simpson will do something. And I don't even *look* at what he's buying or selling. So people will sometimes come up to me and say, "Why did you do that?" And if Lou isn't there, I haven't got the faintest idea why "we" did it.

Cort is an anomaly. But it's been an anomaly for *decades*.

Munger: As to the furniture industry, it's interesting. You can call that an accident. Berkshire now owns the leading furniture retailer in something like six different states. And the companies have somewhat different operating personalities. Now if you add Cort, which is in the so-called "rent-to-rent" end of the furniture business, we're a pretty substantial operator in furniture distribution — I mean, *really* substantial in that trade.

And that happened by accident. Furniture retailing is not generally a good business. But if you get into the very *best* of it — in terms of market share, practices, institutional personality — it's a very fine business for us.

And Cort has had *very* respectable operating numbers for *decades*. It seems like renting furniture couldn't produce such numbers — but it has and does. And that's why we own it.

NetJets is experiencing explosive growth in the U.S.

Shareholder: We came here on NetJets. The pilots told us that you have 700 pilots now and expect to have 1,000 pilots by the end of the year. That strikes me as rather explosive growth. Could you go into that a little bit?

Munger: I *did* go into it. I bought a sixteenth of the cheapest jet. [Munger laughs.]

Europe will be a perfect bitch of a place for us with NetJets.

Shareholder: They also said that they thought the inability to find good pilots in Europe seemed to be a constraining factor there....

Munger: Yeah. Europe will be a perfect *bitch* of a place in which to get up to speed — going into a lot of different countries with a lot of different rules and with the labor and other climates in Europe. We will lose money — we *are* losing money — going into Europe.

But short-term pain will lead to long-term gain.

Munger: But the nature of it is that if you get in there first and do it right and you've been *through* all the indignities, the latecomer is going to have *all* the indignities and trouble plus he'll have NetJets there. And if you think *we're* having troubles, boy is *he* going to have troubles.

So that's what encourages people to suffer like that. And Coca-Cola's done that all over the world — they've suffered like *hell* to go into difficult places. And look how well it worked in the end. That's what NetJets is doing in Europe. We're suffering for the long-term future....

IF HISTORY IS A GUIDE, EXPECT THE UNEXPECTED.
WE TRY TO BE PREPARED FOR THE EXTREMES.

We haven't made big profits with our interest rate insights.

Shareholder: Warren's said that if Alan Greenspan were to whisper in his ear exactly what he was going to do with interest rates, it wouldn't change a thing he does. But do *you* have an opinion about Fed policy? Do you care? Has the higher interest rate environment affected any of your companies?

Munger: Neither Warren nor I has any record of making large profits by guessing what the Federal Reserve is going to do or in which direction interest rates are going.

But if history is any guide, expect the unexpected...

Munger: That said, all intelligent citizens of a modern republic think some about interest rates. In my lifetime, I've seen interest rates at 1% and I've seen them at 20%.

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WESCO FINANCIAL'S
CHARLIE MUNGER
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Now that's one hell of a range. As you sit here, 1% seems *inconceivable*. However, in Japan, short-term interest rates are *under* 1%.

When I was in law school, I think interest rates were about 1-1/2% for a long, long time. Common stocks yielded 6% or 7% and the Dow was a few hundred points. And those low interest rates lasted a long, long time.

And *nobody* really thought we'd ever get a prime rate of 20-21% and government bonds yielding 15-16%. But we *had* those conditions and they lasted a long time.

We try to be prepared for the extremes.

Munger: We try and operate so that it wouldn't be too awful for us if something really extreme happened — like interest rates at 1% or interest rates at 20%. But when they're in some intermediate-type range, we tend to be agnostic about interest rates. We tend to operate as if we just can't guess which direction they're going — and even what the long-term trends are going to be.

Prolonged Japanese downturn contradicts Keynes....

Munger: *Anyone* with any intellectual curiosity has to be flabbergasted by Japan being in this heavy recession for 10 years in spite of taking interest rates down near zero and running a huge government deficit. In other words, they're playing all of the monetary tricks and all of the Keynesian tricks — and yet they still have a recession that has now been about as long as our recession in the '30s, although it's not as severe, of course.

If you'd taken economics at Harvard during the postwar years, you would have been taught basically that that was impossible — that with these modern macroeconomic tricks that wise governments have learned how to play led by Keynes and others, what happened in Japan *can't* happen. But it *has* happened.

Economics by itself isn't enough....

Munger: So I think that interest rates get interesting — what they can do and what they can't do. For example, why does a crazy asset bubble in Hong Kong with a

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collapse that's met with massive government intervention in the stock market result in a pretty temporary downblip in the economic performance of Hong Kong whereas an asset bubble collapse in Japan results in a 10-year recession?

I don't think economics by itself, as traditionally done, will give you the right answer.

Factoring in psychology, Japan is very understandable.

Munger: I think that you've got to mix economics with other disciplines. And when you mix economics with psychology, you can begin to understand the difference.

The truth of the matter is that people in Japan went *catatonic* risk-averse. You could ease up money all you wanted. But the banks who'd lost so heavily and were being criticized so much in a nation where people hate criticism and loss of face, just didn't want to make loans — period — that might cause them more trouble.

Warren always cites the case of Mark Twain's cat that, after a bad experience on a hot stove, never again sat on a hot stove — or a cold stove either. That's what's happened in Japanese banking. They just don't want to make loans because it hurt 'em so much *last* time. And the Japanese consumer is behaving the same way.

Psychology explains the Hong Kong experience, too.

Munger: In Hong Kong, you have a bunch of Chinese. That is a different ethnic group. The love of gambling and the love of action among the Chinese compared to the Japanese — that's just two entirely different conditions.

Taking into account things like that is not in the economics books. But that's because the economics books are wrong. Economics will make better predictions when it learns to take in more and more from the other disciplines.

By the way, it's been pretty good at that over the years. Of all the crazy, self-centered social science disciplines, economics has been the best at being a kleptomaniac — just running out and stealing anything that works from some nearby discipline. And that's very much to the credit of economics, but they haven't carried it far enough. And when they do, they'll be able to make better explanations — or so it seems to this assistant headmaster of a cult.

Interest rates are important, but they're also unknowable.

Munger: At any rate, interest rates are a *very* interesting subject. And for you people that are thinking about what common stocks are going to do for yourselves and your clients, interest rates matter *terribly*.

If interest rates go to 3% and stay there, you could say our better stocks are too *cheap*. But if, like us, you figure you can't really predict interest rates, then you've got to be making investment decisions in some other way. Similarly, of course, if interest rates are going to go to 9% or 10% and stay there, that's a very different world for common stocks.

But I think that *predicting* interest rates is very tough. I'm not saying somebody might not be able to predict some short-term blips here or there by being either exceptionally shrewd or well-connected. But if you ask people to predict

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WESCO FINANCIAL'S
CHARLIE MUNGER
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what interest rates are going to be a year or two in advance — or five years in advance — I think their predictive power gets down pretty close to zero.

I think you can predict a *range*. I think it's quite unlikely that they'll go below 1% or above 20%. However, once you get outside of a big range like that, I think it gets a lot tougher.... That may be more about interest rates than you want to hear.

With the proper tools, Japan is no great puzzle.

Munger: And I'm not kidding when I say that the economics profession has been horribly surprised by what's happened in Japan — the fact that their recession has just gone on and on and on.

I'm not surprised. And that's just because I'm using a *slightly* different model. Can you imagine standing up at an economics convention and saying that that happens in part because the Chinese are so different from the Japanese? My *God*, it wouldn't even be politically correct.

I WORRY ABOUT PROSPERITY BASED ON CREDIT.
THERE *MUST* BE A MORE SOUND WAY OF DOING IT.

Recent economic nirvana was aided by credit expansion.

Shareholder: Do you believe the Fed *needs* to slow things down? Also, do you see inflation?

Munger: It's hard to imagine a mature, unionized, civil-service-pervaded economy like that of the United States performing much better than it has over the last few years. It has to be something pretty close to optimal given the natural constraints of the system.

And that, of course, has involved a fair amount of credit expansion. We've pushed credit card lending and we've pushed asset lending. Everybody leases automobiles instead of buying them. I don't think that's necessarily true in this room, but it's generally true in the civilization.

And it's hard for me to imagine it getting much *better*. I can conceive of various ways in which it could get *worse*.

I think Greenspan's right to be worried.

Munger: So you'd have to say based on the record to date, Greenspan and his crew have a remarkable record. And I think he's right to be worried about asset bubbles.

In fact, the relation of national policy to asset bubbles is a very interesting subject. You had a huge asset bubble in Kuwait that amounted to a vast chain letter scheme of speculation with some crazy ... check-kiting scheme. Basically, the government came in and bailed 'em out. Otherwise, the whole *country* would have been broke. It was a mass mania. However, they have a lot of oil — and they were able to kind of bail people out.

Then you got the Hong Kong bubble where you had massive intervention in the stock market directly by the government of Hong Kong. And the enterprising Chinese, who don't go into a catatonic state of fear with the first reverse — or the second or third — quickly bounced back.

Where else did we have an asset bubble? Well, Warren cited the farmland bubble, where people basically bid the price of farmland up to three times what could be justified by the natural income from owning a farm. And that bubble broke many banks and caused a lot of trouble. But it went away and it didn't sink the economy.

There *has* to be a more sound way of doing it.

Munger: I worry a little about prosperity that comes from constant pushing of the envelope of credit expansion. Some of the world's great growth periods — such as Germany after World War II — occurred without any assistance from that kind of massive credit expansion. There *has* to be a more sound way of doing it than what we're doing now.

The credit system's been pushed about as far as it can go.

Munger: You'd think that eventually we'd get to a place where we pay a price for constantly getting next year's expansion by pushing the credit system a little further. For example, how much farther can you push credit in automobiles when you're already leasing them guaranteeing a residual value with no down-payment? And of course, some of the venture capital financing is getting very gamey. So we've pushed [the credit system] pretty hard in a lot of places already.

I think all intelligent people that have been here for a long time tend to worry a little about asset bubbles and credit expansions. And Greenspan's plainly correct to be making clucking noises and warnings on those subjects.

HIGH HOUSING PRICES DO CAUSE PROBLEMS.
BUT I DON'T THINK WAITING IS THE SOLUTION.

If you think there was a rally in technology *stocks*....

Shareholder: Silicon Valley's housing prices are exorbitant and interest rates are not doing anything to help lower the prices because people are buying based on stock options.

I'm wondering what your opinion is on salaries in general in Silicon Valley — inclusive of stock options — and how wage-earners might migrate away from the Valley and create a generalized recession in that area?

Munger: Well, I think you're right to call attention to Silicon Valley housing prices. There has been nothing that extreme in my long life — not even Florida prices in the '20s. The Munger Professor of Business at Stanford Law School bought a moderate kind of a house when he started teaching at Stanford for $400,000. Well, that house is worth $4-1/2 *million* now. And it's not that big a house. So there's never been anything quite like it in the previous history of the world.

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WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

And booms in housing prices cause all kinds of problems.

Munger: And it does cause problems when housing prices get so high. If you're going to have a servant class, they're going to have to migrate in from a long way off — which causes all kinds of envy effects. The accident of who bought a house five years ago and who didn't causes an enormous change in life outcomes. It causes all kinds of envy. It's *disruptive* to have a boom in housing prices on the scale that you're right in the middle of. It's a *very* extreme condition.

But if you wait for the old prices, you'll be living elsewhere.

Munger: But whether it will get *more* extreme or have a big bust is an interesting question. I'd bet a lot of money that it will not be a total long-term bust. I don't think Silicon Valley is going back to the desert. In other words, Palo Alto's a wonderful place to live, educate your children, be surrounded by a lot of brilliant people and enjoy a wonderful climate.

So if you wait for the real old time prices and you want to live in Palo Alto, I think you're going to spend your life somewhere else.

IF THE INTERNET IS THE PROBLEM,
THERE MAY BE NO SOLUTION....

Internet will change things significantly. Even at See's....

Shareholder: At Berkshire's last two annual meetings, Warren opined that brands are going to become even more important over the internet. Would See's ever consider paying slotting fees to AOL or Yahoo so that when someone searches for "chocolate" or "candy", the first company that it pulls up is See's Candy?

Munger: We don't have any absolute rules about which kinds of sales promotion techniques we use at See's. See's is already selling through the internet the equivalent of about three or four stores' annual sales. And it's some of the best business we have — because we get the same price with a fairly low-cost system of distribution.

I wouldn't regard See's as *the* most ideal candy to sell over the internet because there's a problem of maintaining quality when you send it out into the August heat no matter what delivery system you use. Nonetheless, See's is changing its delivery system somewhat based on the existence of the internet.

Everywhere in Berkshire, we encourage people to adapt to the new reality — which is that the internet is going to be a big thing and it's going to significantly change the way things are done from how they were done before.

But what's good for consumers *won't* be good for investors.

Munger: But from *your* point of view — you investors — there's a *very* interesting aspect of the internet that gets little attention from the people promoting stocks in the new order of things. And that is that high profits on capital in corporations with passive shareholders are made possible in many cases by information inefficiencies.

Take the Berkshire subsidiary, Precision Steel, that sells steel in minor quantities cut to order — sometimes fabricated a bit to order. The information disadvantage many of our customers are at makes us the best solution. "I need a small, specialized quantity of steel — and I need it fast. So I'll call Precision. They're always reliable. They'll deliver it."

But if you create an internet system where every damn piece of steel in America similar to what they need can be punched up on a computer and there's an easy way to punch in whoever has the piece of steel, maybe that will make it better for the buyers and worse for the sellers. Maybe the seller's economic advantage, which is real, will be reduced.

The wealth of the world goes way *up* when we squeeze inefficiencies out of distribution and inefficiencies out of market effects. But in that squeezing, there may be an averaged-out, general compression *downward* of returns on capital in corporate America — just as better textile machinery didn't really help the textile companies. The profits from better textile machinery came to you people when you put on your pajamas and when you wipe yourself after a shower. On the other hand, they didn't come to the textile companies at *all*.

If the internet is the problem, there is no solution....

Munger: All kinds of technical interventions that are wonderful for the civilization are not necessarily wonderful for the passive owners of the common stocks. A really efficient system that gets closer to an auction and makes it very easy for anybody wanting anything to know all the people who have it available for sale may well compress profit margins, on *average*, throughout America — and, indeed, throughout the *world*.

So everybody talks about the internet as if it has to be wonderful.... But on average, it may be very bad for you people to the extent that you want to live passively on common stocks — and bad for me, too.

I consider it quite *likely* that margins will be compressed by this greater bandwidth. Why *wouldn't* they be? If so, then there's no great general antidote for it. It's just one more limitation in life — much like getting old. You can *adapt* to it, but you can't *fix* it....

A FALLING TIDE DROPS MOST BOATS.
WE CAN SHOW YOU THE SCARS....

We've seen high margin businesses become commodities....

Munger: When IBM was forced to give up its tab card monopoly, Warren invested in one of the little companies

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WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

that was created to use the IBM tab card machinery and so forth and sell tab cards in competition with IBM. And they sold big clumps of tab cards — *everything* was tab cards — to the telephone company, department stores, etc.

But the tab card orders were so big that they were put out to competitive bidding after there were several sellers of IBM tab cards. And the prices got horribly *lower*. After all, a tab card is a *commodity*. One tab card properly made is very much like another. And when IBM had a monopoly on the damn things, they made 25% or more of the profit of the whole company out of the tab cards alone.

By the way, they had no patent on the tab card or its structure. They had a patent on the press that made the tab card that enabled their presses to go faster than other presses. That was a monopolistic situation that arose out of practice evolution and accident and God knows what. But it was no impregnable patent or intellectual property position that gave IBM its enormous advantage.

It's just that the tab card cost so little in reference to the cost of the total computing operation that people didn't like compromising with the possible quality of the tab card. Whatever it was, once there were a bunch of companies out there using IBM's presses and there was competitive bidding, the price of tab cards went way the hell down — especially on the big orders to the government and so forth that involved competitive bidding.

There will be some big winners. But *average* returns....

Munger: Why isn't that going to happen in product after product? It's only fair to turn [your question] around. Does anybody have an explanation of why that's *not* going to happen with the increased efficiency of the internet? So that *I* get some instruction instead of just giving it all the time, would somebody please rise and tell me?

Shareholder: I could take a shot at that. What I care about as an investor more than the actual profit margin is return on capital. So when I look at the very high returns on capital being generated by very low margin businesses — like Costco, Staples, Home Depot and Dell — the efficiencies squeezing margins at one end are also allowing companies to get rid of massive amounts of inventory and vastly increase their productivity.

And I think PC manufacturing is a sector where pricing's come under *immense* pressure, but as a sector, there have been such vast gains in productivity and all that the returns on *capital* [haven't been hurt]. Obviously, Dell and Gateway have been the biggest beneficiaries because of a superior economic model. But I would argue that throughout the entire industry, efficiencies have increased dramatically and enhanced shareholder value.

So isn't it possible that those efficiencies could actually squeeze margins, increase capital efficiency and reward shareholders?

Munger: Well, that's why I so carefully talked about *average* returns on capital. Obviously, somebody that seizes on a wonderful position aided by a new technology could worm his way into an economic niche that's ungodly profitable like Costco's. But that does not mean that the development of Costco is wonderful for the profits of retailing *generally*.

I would argue that the Costco model is wonderful for *Costco* and it's wonderful for the *consumer*. But as another retailer, I would not look with joy at the coming of Costco to my town — or Wal-Mart either, for that matter.

If we're all going to excel, average returns may not matter.

Munger: I'm talking about average results. Sure — if they send you on 50 missions over Germany to go into the flak and so forth and if you're the one that ... doesn't get shot down, you're going to have a very entertaining 50 missions and it isn't going to hurt you much. But averaged out, it's not a very wonderful activity to be in. I was talking about *average* results in capitalism.

It's quite clear that there will be many big winners in new models of distribution. I think you're totally right on that. But I suspect that averaged out, it's going to squeeze. And I was talking about averaged-out returns for [investors in common stocks].

If everybody in this room could be in the top 10%, then we wouldn't have to worry about average returns, right? But if we *can't*, why then, we face a development which may be squeezing us all.

THE INTERNET WON'T HURT EVERY BUSINESS.
AND FOR SOME, THE JURY'S STILL OUT.

Newspapers have more downside today.

Shareholder: Looking out, what do you see as the future of the newspaper industry?

Munger: Well, it's way less certain to be wonderful than it was 20 years ago. And what threatens it, of course, is alternative mediums for delivering information. And they threaten it in two ways: For the person that wants information and the person who wants to buy something.

Every newspaper is trying to arrange to be a big winner in the age of the internet by parlaying its advantage in the area of print and paper into an advantage in a world that's mixed print and paper and internet commerce.

But because that is way less sure than the continued growth of print and paper was 20 years ago, I think the enterprises have more *downside* today. Some people think they have more upside. That's what makes life interesting. But I am less convinced of that.

Shareholder: Do you foresee the demise of the printed paper?

Munger: No, I don't think they'll ever disappear. But

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WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

the fabulous economics could be grievously impaired.

Internet won't be as big a deal for trading of electricity....

Shareholder: You and Warren have said you expect decent returns from MidAmerican. But in thinking about the application of the internet to commodity businesses, it's a little hard to see why that would happen since Warren said at the annual meeting that MidAmerican has no cost advantage.

Munger: Where I grew up in the old days, there was a flour broker named A. Horace Erickson who traded flour out of one office. All of these flour mills, which were the equivalent of electric plants in some respects, would need to balance out flour. So they'd all do these elaborate trades with A. Horace Erickson. It was a very efficient system for flour milling — and it also made A. Horace Erickson rich even though he got a tiny little percentage of each trade.

My point is that the world was capable of doing that with flour back in 1937 with nothing but telephones. And I don't think electricity trading will be *helped* as much by the internet as a lot of other things....

Generation/delivery are more important in this business.

Munger: But the business of generating and delivering massive amounts of electricity — that is the ultimate business requiring a big tangible system as distinguished from just a little information going over wires. So I wouldn't expect the internet to have fabulous changes on a business like that.

Obviously, *anything* can be made more efficient with more bandwidth and more computing power. But I think the delivery and generation is a bigger part of the business. And I just don't think that that is one where the internet's going to have huge incremental effects....

TODAY, WE FACE A *DOUBLE* DISADVANTAGE.
FORTUNATELY, WE HAVE ADVANTAGES, TOO.

Being bigger makes it much harder. It limits our options.

Shareholder: You've spoken about how much harder it is to make a large return on capital with the capital base that Berkshire has now than it would be if it were smaller.

Munger: Yes, although we have no desire to go back to that easier time.

Shareholder: Is that something that in your mind and Warren's mind needs to be reconciled either via buybacks [or dividends]? I know Warren says he must have been on the toilet the last time he thought of paying a dividend. However, with all your cash, whether there are earnings per share now or not, I think it's clear to most observant minds that Berkshire is generating a lot of cash — or will generate a lot of future cash.... So I'm wondering what your thinking is as you look forward. Or is it simply, "We'll have a lot of cash and we'll produce smaller returns."

Munger: There are *two* things that make it harder now for us in terms of operating in marketable securities. First, we're so big we can only look at pretty big companies. That makes it *much* harder. Our options are limited — and we're going into more competitive areas that are more closely examined by very smart people like Alice Schroeder. [Munger laughs]. People like Alice make it more difficult for us when we get into these bigger companies.

We actually face a *double* disadvantage....

Munger: Plus, I totally agree with Warren's article in *Fortune* which we sent out to Berkshire shareholders. I think the current climate offers probable prospects for the ordinary investor in common stocks that are *way* lower over the next 15 or 20 years than we've been used to over the last 15 or 20 years.

So we face a *double* disadvantage. We've got kind of an irritatingly limited climate in terms of potentiality. And we have restrictions on our own options because we've gotten so rich. Now this isn't my idea of the worst tragedy I've heard of in the history of Western civilization. And you will find us quite *contented* with our disadvantages. Nonetheless, they do affect what we can do.

But we have advantages, too.

Munger: There are also some *good* things in our present position. We have *enormous* flexibility. You're right — Berkshire will be accumulating *billions* of dollars of cash every year. Wesco will be accumulating cash. And we have a structure that allows us enormous flexibility.

Also, unlike a lot of portfolio managers, while we can't buy stock in small companies with any realistic prospects for us because of the size considerations, we get whole companies offered to us now by people who like and are good at running them. And that is not happening at most investment counseling operations. So we have a string to our bow that other people *don't* have. And who *knows* how big that string may eventually get to be.

So we've got great flexibility and a certain discipline in terms of not doing some foolish thing just to be active — discipline in avoiding just doing any damn thing just because you can't stand inactivity. And that's a very advantageous position.

What was it Mr. McCawber used to say? "Something will turn up." And something always *has* turned up for us.

And we are, in a slow kind of way, finding things to do.

Munger: You can say, "Well, but you do odd things — like buying a company that distributes electricity in Iowa and England." You can say, "What the hell is happening at Berkshire Hathaway?"

Well, I think that is a perfectly decent investment.

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WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

Not only that, it gives us a window into a field where a lot of craziness is going on. And we've been good at dealing with some kinds of craziness. Get us into a field where a lot of craziness is going on and we may find something *else* intelligent to do.

So we are, in a slow kind of way, finding things to do. And we do have a flexibility which is very welcome in terms of our overall position.

But don't expect the magic of the *last* 15 years in the *next*.

Munger: So I'm not discouraged. I just don't think it's going to be *anything* like, for you shareholders, in the *next* 15 years — and I'm not talking about what you do with your money elsewhere — what you're used to....

But I think I know many of you well enough to know you don't have that many other wonderful ideas either. In other words, *you* have some of the problem that *we* have.

NOT GETTING RICH FASTEST IS NO TRAGEDY. BUT TRYING TO DO SO CAN *LEAD* TO ONE....

Someone getting richer faster than you is no great tragedy.

Shareholder: The last couple of years have certainly been different than anything I've ever experienced in my lifetime. And I'd just love to hear your frank observations on the silliness that appears to be going on with maybe some psychology mixed in with the answer.

Munger: Well, I think there's one big truth that the typical investment *counselor* will have difficulty recognizing, but the guy who's investing his own money ought to have no trouble recognizing: If you're comfortably rich and you've got a way of investing your money that is overwhelmingly likely to *keep* you comfortably rich and someone else finds some rapidly growing something-or-other and is getting richer a lot faster than you are, that is not a big tragedy.

Don't let the inevitable make you miserable.

Munger: And if you're not comfortable and don't understand the fact that somebody else is getting rich faster, so *what*? How crazy it would be to be made miserable by the fact that someone else is doing better — because someone else is *always* going to be doing better at any human activity you can name. Even Tiger Woods loses a lot of the time.

Look at the trouble Stanley Druckenmiller got into. He thought he was absolutely *required* to always beat everybody else. And even when it seemed kind of silly to him, he thought, "Well, I can't be *out* of it."

Just avoid the *really* big trouble....

Munger: A lot of success in life and success in business comes from knowing what you really want to avoid — like early death and a bad marriage.... There are a lot of things that are *really* big troubles. And if you give them a wide berth, your life works a lot better.

And if somebody else is having a lot of fun with Zsa Zsa Gabor, why, you can say, "Pass this cup from me."

WE WERE LUCKY TO START WHEN WE DID. IT'S LIKELY TO TAKE YOU LONGER....

We were lucky to come into the business when we did....

Shareholder: What would you buy today, if you were 30 years younger, with the capital you had then — which you won't answer, I'm sure.

Munger: I think having a little capital now and being young gives one lower opportunities than, in retrospect, were available to me. I was lucky that I came in in the aftermath of the '30s when people were demoralized, when whole generations didn't want to buy common stocks and trust departments didn't want to hold common stocks. There'd been a lot of bad financial practice in the '20s that made people morally revolted at capitalism. I'm talking about the Insull utility holding companies, etc., etc. and Goldman Sachs' trading company.

As Eddie Cantor said, "They told me to buy this stock for my old age and it worked perfectly. Within six months, I felt like an old man." Coming into investing in that aftermath when there'd been a lot of failure and disgrace was a great advantage to people like Warren and me.

You may be able to *do* it. It's just likely to take *longer*.

Munger: Now a young person starting out today when you've had roughly 20 years of 15% returns from common stocks, way less disgrace, more achievement and so on, I'd say in the nature of things it's somewhat tougher for you for the reasons that Warren outlined in that article that appeared in *Fortune*....

That doesn't mean if you adopt the same catechism — the same mindset that we did, the same patience, the same decisiveness and willingness to bet on the few occasions when you get the wonderful opportunity to bet that you can recognize as such — that you won't do very well. It just means that it's likely to take *longer* in your case.

But what the hell, you will *live* a lot longer.... And it will fill in the years.

—OID

The preceeding excerpt was the Wesco Financial segment of this edition's 27-page feature on the annual meetings of Berkshire Hathaway and Wesco.

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Charlie Munger Speaks

Notes from the Wesco Annual Meeting

By Whitney Tilson
May 15, 2000

As an admirer of Warren Buffett and a **Berkshire Hathaway** (NYSE: BRK.A) shareholder, I make a point of attending the company's annual meetings so I can learn from the answers to dozens of questions from his shareholders. Sharing the stage with him is Charlie Munger, Berkshire Hathaway's Vice Chairman and Buffett's long-time partner.

The dynamic is pretty funny to watch: Buffett generally takes the first stab at answering a question, but after giving his answer turns and says, "Charlie?" Munger, immobile and expressionless throughout the day (they could easily substitute a mannequin for quite a while and no-one would notice), typically replies, "I have nothing to add."

But as you can see from my notes from this year's meeting (summarized in my previous column), Munger often does have something to add, and it is invariably sharp and insightful. In many ways, he's more entertaining than Buffett because he doesn't pull any punches (I think his "mixing raisins and turds" line will go down in Berkshire history).

Over time, I have come to realize that Munger is a genius in his own right, and has had a profound effect on Buffett's thinking (which Buffett freely acknowledges). So who is this "cranky, old fashioned" man (to use his words)? I think many of the answers will be revealed in Janet Lowe's upcoming book, *Damn Right*, which she tells me will be available in October. But I wanted to find out for myself, so I recently attended **Wesco Financial's** (AMEX: WSC) annual meeting, where Munger, the company's long-time Chairman, took questions from shareholders for two hours. (Since 1973, Berkshire Hathaway has owned 80.1% of Wesco. I am a Wesco shareholder and plan to write a future column about the company and why I believe it's attractively priced.)

As I did in my last column, I will try to distill my notes down to the most important things I heard. Note that in some cases I am paraphrasing because I couldn't write quickly enough.

Opening Statement

"This only masquerades as a shareholder's meeting. It's really a gathering to hear the thoughts of the assistant headmaster of a cult."

Comments on Berkshire Hathaway and Wesco

Making the Right Personnel Decisions

"It's amazing how few times over the decades we've have to remove a person -- far less than other companies. It's not that we're soft or foolish, it's that we're wiser and luckier. Most people would look back and say their worst mistake was not firing someone soon enough. [We don't say that.] Our record is fabulous. We're old-fashioned. For example, in the case of CORT Business Services [a furniture rental business that Wesco acquired this year], Warren said to me, 'You're going to love Paul Arnold [CORT's CEO].' And he was right. Paul's been running the business since he was in law school and loves it.

Berkshire Hathaway's Culture

"There are certain virtues that are common in all of Berkshire's subsidiaries. We don't create them -- we select companies that have them already. We just don't screw it up."

Writing More Insurance

"Both Berkshire Hathaway and Wesco write amazingly low amounts of insurance relative to our surplus. It gives us investment flexibility. We just don't find enough insurance to write -- we'd do more if we could. Writing insurance equal to 10% of surplus for Berkshire Hathaway would be hog heaven -- we don't come close to that. Wesco didn't either, but we took on one big policy this year."

Lumpy Results

"That is one of our advantages as an insurer -- we don't give a damn about lumpy results. Everyone else is trying to please Wall Street. This is not a small advantage."

Risks to Berkshire Hathaway from Large Super Cat Losses

"We don't write big super cat contracts where there's no upper limit [cat means catastrophe; for example, insuring against a large earthquake in California]. It's inconceivable that we'd lose more than 6-7% of the company's assets after tax in one event. The real risk is borne by insurers who write, for example, basic homeowner's policies against a storm or earthquake and don't lay off some of that risk. That's roughly what happened to 20th Century, where they lost 100% of their capital in the Northridge (CA) Earthquake due to writing lots of little policies concentrated in an earthquake area."

Buffett's Successors
A shareholder noted that Berkshire Hathaway's succession plan calls for two people to replace Buffett: one to make the investments and one to oversee the operating companies. Lou Simpson of GEICO has been designated (at least unofficially) for the former position, so the shareholder asked, "Could you share with us who has been designated for the latter role?" Munger's succinct reply, "I could but I won't." [In the past, Buffett has defended his decision not to reveal this person because he might change his mind and wants to avoid the media circus that would invariably occur were this to happen.]

Why Not Use Wesco to Make Smaller Investments?
A shareholder noted that Buffett and Munger have long maintained that Berkshire Hathaway's size makes finding attractive investments difficult. Why then, he asked, don't they use Wesco to make smaller investments? Munger replied, "Lou Simpson will occasionally do smaller investments. But we're not set up to do small investments. Also, Warren and I are idiosyncratic and are unlikely to change our spots."

Berkshire Hathaway Repurchasing Shares
"In the past, when Berkshire has gotten cheap, we've found other even cheaper stocks to buy. I'd always prefer this. It's no fun to have the company so lacking in repute that we can make money for some shareholders by buying out others."

Why Don't More Companies and Investors Copy Berkshire Hathaway?
"It's a good question. Our approach has worked for us. Look at the fun we, our managers, and our shareholders are having. More people *should* copy us. It's not difficult, but it looks difficult because it's unconventional -- it isn't the way things are normally done. We have low overhead, don't have quarterly goals and budgets or a standard personnel system, and our investing is much more concentrated than average. It's simple and common sense.

"Our investment style has been given a name -- focus investing -- which implies 10 holdings, not 100 or 400. Focus investing is growing somewhat, but what's really growing is the unlimited use of consultants to advise on asset allocation, to analyze other consultants, etc.

"I was recently speaking with Jack McDonald, who teaches a course on investing rooted in our principles at Stanford Business School. He said it's lonely -- like he's the Maytag repairman.

"I was in the ROTC for six years and saw a very limited culture [in the military] with few new ideas. It's the same elsewhere"

Future Outlook for Berkshire Hathaway
"The future will be harder for Berkshire Hathaway for two reasons:

1) We're so big. It limits our investment options to more competitive areas that are examined by very smart people like Alice Schroeder [Paine Webber's insurance analyst, who was sitting in the audience].
2) The current climate offers prospects in common stocks over the next 15-20 years that are *way* less than we've experienced over the past 15-20 years. Read Warren's *Fortune* article -- I totally agree with it.

"But this is not a tragedy. We're content. Berkshire Hathaway and Wesco will accumulate cash every year, and we have a structure that gives us enormous flexibility. While we're too big to buy the stock of a small company, we have the advantage of having entire companies offered to us. Something has always turned up for us. I'm not discouraged, but I don't think your money here is going to do anything like what you're used to."

Charlie Munger Speaks - Part 2

Notes from the Wesco Annual Meeting

By Whitney Tilson
May 15, 2000

Comments on Businesses
Coca Cola
"Over the next 20-30 years, Coke will be selling more soda and other drinks. They will also be able to raise prices moderately and increase margins. Therefore, if you own Coke, you'll do all right. [Regarding the stock's high valuation,] if you project growth long enough into the future, you can get high current valuations. So what you're seeing in Coke's stock price is the residual prediction that despite its recent stumbles, they'll be coloring a lot more water 20 years from now."

The Furniture Business

"Berkshire Hathaway now owns the leading furniture retailer in six states and, through CORT, has a substantial position in the rent-to-rent [as opposed to rent-to-own] furniture business. This all came about by accident. The furniture business is generally not a good one, but if you own the best companies, it's a fine business for us. It seems like CORT's business wouldn't be a good one, but it is."

MidAmerican Energy
"Who would have thought we'd buy an electric company in Iowa? But this is a perfectly decent investment. It also gives us a window into a field where a lot of crazy things are going on, which may give us other opportunities [see the discussion of the real options that MidAmerican has in my recent column]."

Net Jets' Expansion into Europe
"Europe is a bitch of a place to get into, with all its countries and rules. We are losing money and expect that this will continue for a while. But look at the situation faced by the 2nd mover: all the same troubles and we're already there. Coke has done this all over the world and look how it's paid off."

The Newspaper Business
"It is way less certain to be a wonderful business in the future. The threat is alternative mediums of information. Every newspaper is scrambling to parlay their existing advantage into dominance on the Internet. But it is way less sure [that this will occur] than the certainty 20 years ago that the basic business would grow steadily, so there's more downside risk. The perfectly fabulous economics of this business could become grievously impaired."

General Comments

Earnings Manipulation and Accounting Shenanigans
"With so much money riding on reported numbers, human nature is to manipulate them. And with so many doing it, you get Serpico effects, where everyone rationalizes that it's okay because everyone else is doing it. It is always thus.

"Now, it's chain letter mechanics. Because it's mixed with legitimate activities like venture capital, it looks respectable. But we're mixing respectable activity with disrespectable activity -- hence my comment at the Berkshire Hathaway annual meeting about if you mix raisins with turds, you've still got turds. There is nothing in accounting that can prevent unscrupulous managers from engaging in a chain-letter-type fraud.

"I hate with a passion GAAP [Generally Accepted Accounting Principles] as applied to derivatives and swaps. JP Morgan sold out to this type of accounting to front-end revenues. I think it's a disgrace."

Interest Rates

"Neither Warren nor I have any record of making large profits from interest rate bets. That being said, all intelligent citizens of this republic think a bit about this. In my lifetime, I've seen interest rates range from 1% to 20%. We try to operate so that really extreme interest rates in either direction wouldn't be too bad for us. When interest rates are in a middle range, as they are now, we're agnostic."

Japan's Recession

"Anyone has to be flabbergasted by Japan's recession, which has endured for 10 years, despite interest rates below 1%. The government is playing all the monetary games, but it's not working. If you had described this situation to Harvard economists, they would have said it's impossible. Yet at the same time, there's an asset bubble in Hong Kong. Why? Because Japan and China are two vastly different cultures. The Chinese are gamblers.

"This is a classic example of why, to be a successful investor, one must draw from many disciplines. Imagine an economist standing up at a meeting of economists and giving my explanation. It wouldn't be politically correct! But the tools of economics don't explain what's going on."

Advice to Other Investors

Opportunities for Small Investors

"If you have only a little capital and are young today, there are fewer opportunities than when I was young. Back then, we had just come out of a depression. Capitalism was a bad word. There had been abuses in the 1920s. A joke going around then was the guy who said, 'I bought stock for my old age and it worked -- in six months, I feel like an old man!'

"It's tougher for you, but that doesn't mean you won't do well -- it just may take more time. But what the heck, you may live longer."

Practice Evolution

"This is really important. For example, Hertz and Enterprise Rent-a-Car through practice

evolution have developed personnel systems, etc. that work for them. They are like different species in similar ecological niches.

"Common stock investors can make money by predicting the outcomes of practice evolution. You can't derive this by fundamental analysis -- you must think biologically.

"Another example is Tupperware, which developed what I believe to be a corrupt system of psychological manipulation. But the practice evolution worked and had legs. Tupperware parties sold billions of dollars of merchandise for decades.

"We wouldn't have bought CORT if we didn't like the culture, which resulted from long practice evolution."

Mental Models for Investing
"You must know the big ideas in the big disciplines, and use them routinely -- all of them, not just a few. Most people are trained in one model -- economics, for example -- and try to solve all problems in one way. You know the old saying: to the man with a hammer, the world looks like a nail. This is a dumb way of handling problems."

Be Satisfied with What You Have
"Here's one truth that perhaps your typical investment counselor would disagree with: if you're comfortably rich and someone else is getting richer faster than you by, for example, investing in risky stocks, *so what*?! Someone will *always* be getting richer faster than you. This is not a tragedy.

"Look at Stanley Druckenmiller [who ran one of George Soros' funds, which is essentially being shut down due to large losses in speculative tech and biotech stocks]: he always had to be the best and couldn't stand that others were beating him by investing in these sectors.

"A lot of success in life and business comes from knowing what you want to avoid: early death, a bad marriage, etc."

Recommended Books and Comments on Silicon Valley
Munger was asked to name his favorite books of all time. He replied, "That's hard because I mix ideas from so many books. One fabulous book is The Selfish Gene, which provides basic insights on human conditions. [In the past, Munger has strongly recommended Influence: The

Psychology of Persuasion, which I just read and liked enough to add it to my list of all-time favorite books related to investing.]

Later, Alice Schroeder, who covers the insurance industry for Paine Webber, asked if he'd read The New New Thing, Wall Street On Sale or the new translation of Beowulf. He had only read the former, and commented: "It was interesting enough for me to finish it. In some respects it describes an appalling culture. While Silicon Valley has made great contributions to society, some things come pretty close to 'the unacceptable face of capitalism.'"

EVA
Asked to elaborate on his comments at the Berkshire Hathaway meeting on Stern Stewart and their concept of Economic Value Added, Munger said:

"It's obvious that if a company generates high returns on capital and reinvests at high returns, it will do well. But this wouldn't sell books, so there's a lot of twaddle and fuzzy concepts that have been introduced that don't add much -- like cost of capital. It's accepted because some of it is right, but like psychoanalysis, I don't think it's an admirable system in its totality."

A number of people have asked whether I agree with Munger's dismissal of EVA. Sort of. I agree with his comment about the "twaddle," but fear that he may have deterred people from studying and understanding return on invested capital -- the single most important metric I consider when evaluating a company. Sure, Bennett Stewart's book, The Quest for Value, is unbearably dense, but ROIC is *not* a difficult concept nor is it difficult to calculate. For an understandable (not to mention free) take on ROIC, I recommend the Fool's School, A Look at ROIC, and Paul Johnson's Introducing ROIC as an Economic Measure (focus on pages 1-9 and 35-37). Johnson is one of the authors of The Gorilla Game, my favorite book on tech investing.

-- Whitney Tilson

WESCO FINANCIAL CORPORATION

Annual Report 2000

Form 10-K Annual Report 2000

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated net ''operating'' income (i.e., before realized securities gains shown in the table below) for the calendar year 2000 increased to $70,087,000 ($9.84 per share) from $46,872,000 ($6.58 per share) in the previous year.

Consolidated net income increased to $922,470,000 ($129.56 per share) from $54,143,000 ($7.60 per share) in the previous year.

Wesco has four major subsidiaries: (1) Wesco-Financial Insurance Company (''Wes-FIC''), headquartered in Omaha and engaged principally in the reinsurance business, (2) The Kansas Bankers Surety Company (''KBS''), owned by Wes-FIC and specializing in insurance products tailored to midwestern banks, (3) CORT Business Services Corporation (''CORT''), headquartered in Fairfax, Virginia, purchased in February 2000 and engaged principally in the furniture rental business, and (4) Precision Steel Warehouse, Inc. (''Precision Steel''), headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended			
	December 31, 2000		December 31, 1999	
	Amount	Per Wesco Share[2]	Amount	Per Wesco Share[2]
Operating earnings:				
Wes-FIC and KBS insurance businesses	$ 45,518	$ 6.39	$44,392	$6.23
CORT furniture rental business	28,988	4.07	—	—
Precision Steel businesses	1,281	.18	2,532	.35
Goodwill amortization	(5,867)	(.82)	(782)	(.11)
Other(3)	167	.02	730	.11
	70,087	9.84	46,872	6.58
Realized net securities gains	852,383	119.72	7,271	1.02
Wesco consolidated net income	$922,470	$129.56	$54,143	$7.60

(1) All figures are net of income taxes.

(2) Per-share data is based on 7,119,807 shares outstanding. Wesco has had no dilutive capital stock equivalents.

(3) After deduction of interest and other corporate expenses, and costs and expenses associated with foreclosed real estate previously charged against Wesco's former Mutual Savings and Loan Association subsidiary. Income was from ownership of the Wesco headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the insurance subsidiaries. The 1999 figure also includes net gains on sales of foreclosed real estate and a benefit from the reduction of loss reserves provided in prior years against possible losses on sales of loans and foreclosed real estate.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

Wesco-Financial Insurance Company (''Wes-FIC'')

Consolidated operating earnings of Wes-FIC and KBS represent the combination of the results of their insurance underwriting with their net investment income. Following is a summary of these figures as they pertain to Wes-FIC, excluding its subsidiary, KBS. The operating earnings of Wes-FIC's KBS subsidiary are discussed in the section, ''The Kansas Bankers Surety Company,'' below.

	Pre-Tax Operating Earnings		After-Tax Operating Earnings	
	2000	1999	2000	1999
Underwriting gain (loss)	$ (616,000)	$ 4,359,000	$ (400,000)	$ 2,833,000
Net investment income	53,412,000	44,129,000	38,958,000	34,362,000
Wes-FIC parent company operating income	$52,796,000	$48,488,000	$38,558,000	$37,195,000

As shown above, Wes-FIC's consolidated operating earnings include significant net investment income, representing dividends and interest earned on its portfolio of marketable securities. Wes-FIC's consolidated operating earnings exclude its realized net securities gains, net of income taxes, of $853.1 million in 2000 versus $7.3 million in 1999. Our discussion will concentrate on Wes-FIC's insurance underwriting, not on the results of its investments.

At the end of 2000 Wes-FIC retained about $19 million in invested assets, offset by claims reserves, from its former reinsurance arrangement with Fireman's Fund Group. This arrangement was terminated August 31, 1989. However, it will take a long time before all claims are settled, and, meanwhile, Wes-FIC is being helped over many years by proceeds from investing ''float'' and by favorable loss development, which has enabled it to reduce the liability for losses and loss-related expenses, benefiting after-tax operating earnings by $.8 million in 2000 and $1.7 million in 1999.

Wes-FIC engages in other reinsurance business, including large and small quota share arrangements similar and dissimilar to our previous reinsurance contract with Fireman's Fund Group, and, from time to time, in super-cat reinsurance, described in great detail in our pre-1999 annual reports, which Wesco shareholders should reread each year. Although Wes-FIC was not active in super-cat reinsurance business in 2000, its operating earnings benefited by $.9 million, after taxes, in 1999. On super-cat reinsurance accepted by Wes-FIC to date (March 5, 2001) there has been no loss whatsoever that we know of, but some ''no-claims'' contingent commissions have been paid to original cessors of business (i.e., cessors not including Berkshire Hathaway).

The balance of Wes-FIC's after-tax underwriting profit or loss not described above, amounted to underwriting loss of $1.2 million for 2000 and underwriting profit of $.2 million for 1999.

In all recent reinsurance sold by us, other subsidiaries of our 80%-owning parent, Berkshire Hathaway, sold several times as much reinsurance to the same customers on the same terms. In certain instances, such subsidiaries have taken from us a 3%-

of-premiums ceding commission on premium volume passed through them to Wes-FIC. Excepting this ceding commission, Wes-FIC has had virtually no insurance-acquisition or insurance administration costs with regard to those policies.

Wes-FIC remains a very strong insurance company, with very low costs, and, one way or another, in the future as in the past, we expect to continue to find and seize at least a few sensible insurance opportunities.

Wesco shareholders should continue to realize that recent marvelous underwriting results are sure to be followed, sometime, by one or more horrible underwriting losses from super-cat or other insurance written by Wes-FIC.

The Kansas Bankers Surety Company (''KBS'')

KBS, purchased by Wes-FIC in 1996 for approximately $80 million in cash, contributed $7 million to the consolidated operating earnings of the insurance businesses in 2000 and $7.2 million in 1999. These figures are before goodwill amortization under accounting convention of $.8 million each year. The results of KBS have been combined with those of Wes-FIC, and are included in the table on page 1 in the category, ''operating earnings of Wes-FIC and KBS insurance businesses.''

KBS was chartered in 1909 to underwrite deposit insurance for Kansas banks. Its offices are in Topeka, Kansas. Over the years its service has continued to adapt to the changing needs of the banking industry. Today its customer base, consisting mostly of small and medium-sized community banks, is spread throughout 25 mainly midwestern states. In addition to bank deposit guaranty bonds which insure deposits in excess of FDIC coverage, KBS also offers directors and officers indemnity policies, bank employment practices policies, bank annuity and mutual funds indemnity policies and bank insurance agents professional errors and omissions indemnity policies.

KBS increased the volume of business retained effective in 1998. It had previously ceded almost half of its premium volume to reinsurers; and, it now reinsures only about 5% under arrangements whereby other Berkshire subsidiaries take 50% and unrelated reinsurers take the other 50%. As we indicated last year, the increased volume of business retained comes, of course, with increased irregularity in the income stream.

KBS's combined ratio remained much better than average for insurers, at 73.9% for 2000 and 59.4% for 1999, versus 37.2% for 1997, and we continue to expect volatile but favorable long-term effects from increased insurance retained.

KBS is run by Donald Towle, President, assisted by 15 dedicated officers and employees.

CORT Business Services Corporation (''CORT'')

In February 2000, Wesco purchased CORT Business Services Corporation (''CORT'') for $386 million in cash. In addition, CORT retains about $45 million of previously existing debt.

CORT is a very long established company that is the country's leader in rentals of furniture that lessees have no intention of buying. In the trade, people call CORT's activity ''rent-to-rent'' to distinguish it from ''lease-to-purchase'' businesses that are, in essence, installment sellers of furniture.

However, just as Hertz, as a rent-to-rent auto lessor in short-term arrangements, must be skilled in selling used cars, CORT must be and is skilled in selling used furniture.

In the ten months that we have owned CORT, its revenues have totaled $361 million. Of this, $306 million was furniture rental revenue and $55 million was furniture sales revenue. CORT contributed $29 million to Wesco's consolidated operating income in 2000, before goodwill amortization of $5.1 million or realized securities losses of $.7 million. CORT's pre-tax operating income (before goodwill amortization) for the entire calendar year 2000 was $54.3 million.

Thus, in essence, Wesco paid $386 million for $54.3 million in pre-tax operating earnings. About 60% of the purchase price was attributable to goodwill, an intangible balance sheet asset.

Wesco's consolidated balance sheet now contains about $260 million in goodwill (including $28 million from Wesco's 1996 purchase of KBS). On a full year basis, Wesco's reported earnings for 2000 were reduced by about $6 million of mostly-non-tax-deductible amortization of goodwill. I am pleased to report that the Financial Accounting Standards Board has recently proposed a rule that, if adopted, will no longer require automatic amortization of acquired goodwill. If this proposed rule change goes into effect, our reported earnings will more closely reflect microeconomic reality as we appraise it.

More details with respect to CORT are contained throughout this annual report, to which your careful attention is directed.

CORT has long been headed by Paul Arnold, age 54, who is a star executive as is convincingly demonstrated by his long record as CEO of CORT. We are absolutely delighted to have Paul and CORT within Wesco, are pleased with CORT's performance under his leadership in 2000, and hope to see a considerable expansion of CORT's business and earnings in future years.

Commencing late last year, and continuing to date, new business coming into CORT has declined sharply. We believe that CORT's operations will remain profitable in any likely recession-related decline in the rent-to-rent segment of the furniture business.

The purchase of CORT has increased Wesco's employee count to approximately 3,000 from 275 one year earlier.

Precision Steel Warehouse, Inc. (''Precision Steel'')

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, contributed $1.3 million to Wesco's net operating earnings in 2000, down from the $2.5 million contributed in 1999. The 50% decline in 2000 operating earnings was due principally to two factors: (1) LIFO inventory accounting adjustments decreased after-tax earnings approximately $.4 million in 2000 after increasing such earnings by $.3 million in 1999, and (2) pounds of product sold decreased 3%, while competition restrained prices as costs of principal raw materials increased, causing fewer dollars of gross profit to be available to absorb operating expenses. Revenues were up only 1%.

Generally, the U.S. steel business was a disaster in 2000, and Precision Steel suffered worse effects than occurred for it in previous general declines in the U.S. steel business.

We do not regard earnings changes from LIFO accounting adjustments, up or down, as material in predicting future earning power.

Terry Piper, who became Precision Steel's President and Chief Executive officer late in 1999, has done an excellent job in leading Precision Steel through a very difficult year.

Tag Ends from Savings and Loan Days

All that now remains outside Wes-FIC but within Wesco as a consequence of Wesco's former involvement with Mutual Savings, Wesco's long-held savings and loan subsidiary, is a small real estate subsidiary, MS Property Company, that holds tag ends of real estate assets with a net book value of about $6.5 million. MS Property Company's results of operations, immaterial versus Wesco's present size, are included in the breakdown of earnings on page 1 within ''other operating earnings.''

Other Operating Earnings

Other operating earnings, net of interest paid and general corporate expenses, amounted to $.2 million in 2000 and $.7 million in 1999. Sources were (1) rents ($3 million gross in 2000) from Wesco's Pasadena office property (leased almost entirely to outsiders, including California Federal Bank as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiaries, less (3) general corporate expenses plus minor expenses involving tag-end real estate.

Realized Net Securities Gains

The main tag end from Wesco's savings and loan days was an investment in Freddie Mac common stock, purchased by Mutual Savings for $72 million at a time

when Freddie Mac shares could be lawfully owned only by a savings and loan association. Those shares, carried on Wesco's balance sheet at yearend 1999 at a market value of $1.4 billion, were sold in 2000, giving rise to the principal portion of the $852.4 million of after-tax securities gains realized by Wesco in 2000, versus $7.3 million, after taxes, realized in 1999.

Although the realized gains materially impacted Wesco's reported earnings for each year, *they had a very minor impact on Wesco's shareholders' equity*. Inasmuch as the greater portion of each year's realized gains had previously been reflected in the unrealized gain component of Wesco's shareholders' equity, those amounts were merely switched from unrealized gains to retained earnings, another component of shareholders' equity.

Consolidated Balance Sheet and Related Discussion

As indicated in the accompanying financial statements, Wesco's net worth, as accountants compute it under their conventions, increased to $1.98 billion ($278 per Wesco share) at yearend 2000 from $1.90 billion ($266 per Wesco share) at yearend 1999.

The foregoing $278-per-share book value approximates liquidation value assuming that all Wesco's non-security assets would liquidate, after taxes, at book value. Probably, this assumption is too conservative. But our computation of liquidation value is unlikely to be too low by any large percentage because (1) the liquidation value of Wesco's consolidated real estate holdings (where interesting potential now lies almost entirely in Wesco's equity in its office property in Pasadena containing only 125,000 net rentable square feet), and (2) possible unrealized appreciation in other assets (primarily CORT and Precision Steel) cannot be large enough, in relation to Wesco's overall size, to change very much the overall computation of after-tax liquidating value.

Of course, so long as Wesco does not liquidate, and does not sell any appreciated securities, it has, in effect, an interest-free ''loan'' from the government equal to its deferred income taxes on the unrealized gains, subtracted in determining its net worth. The sale of the Freddie Mac shares in 2000 reduced that interest-free ''loan'' from $705 million as of yearend 1999 to $258 million as of yearend 2000. This interest-free ''loan'' from the government is at this moment working for Wesco shareholders and amounted only to about $36 per Wesco share at year end 2000.

However, some day, additional parts of the interest-free ''loan'' may be removed as securities are sold, as happened to such a large extent with the sale of Freddie Mac stock in 2000. Therefore, Wesco's shareholders have no perpetual advantage creating value for them of $36 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than $36 per Wesco share.

Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. Wesco is not an

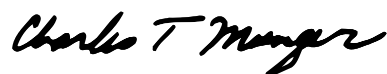
equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway. Moreover, the quality disparity in book value's intrinsic merits has, in recent years, continued to widen in favor of Berkshire Hathaway.

All that said, we make no attempt to appraise relative attractiveness for investment of Wesco versus Berkshire Hathaway stock at present stock-market quotations.

To progress from this point at a satisfactory rate, Wesco plainly needs more favorable investment opportunities, recognizable as such by its management, preferably in whole companies like CORT, but, alternatively, in marketable securities to be purchased by Wesco's insurance subsidiaries.

The Board of Directors recently increased Wesco's regular dividend from 30½ cents per share to 31½ cents per share, payable March 7, 2001, to shareholders of record as of the close of business on February 7, 2001.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.



Charles T. Munger
Chairman of the Board

March 5, 2001

Whitney Tilson's Notes from the 2001 Wesco Annual Meeting

Note: This is not a transcript. No recording devices were allowed at the meeting, so this has been reconstructed from 21 pages of frantic scribbles. I did not take notes on certain questions and answers that I felt weren't very interesting or that repeated what Munger has said many times in the past (or maybe my mind and/or wrist just needed to rest periodically).

Wesco and Berkshire Hathaway

Using Wesco as a vehicle for small investments

I asked Munger the following question: "Mr. Munger, an hour ago someone asked me what Wesco was worth. I threw up my hands and said, 'I don't know. With $1 billion in cash and a $2 billion market cap, Wesco's future returns will be largely dependent on how that cash is allocated.' Can you tell us how you plan to invest that money? In particular, you and Mr. Buffett have been saying for a long time that Berkshire Hathaway's increasing size is an anchor on the percentage rate of return it will be able to generate in the future. You have also said that certain investors with smaller pools of capital could generate very high rates of return. So why don't you use Wesco as your vehicle to do smaller investments, such as those that Mr. Buffett sometimes does in his personal portfolio?"

Munger replied, "Warren spends 70 hours a week thinking about investing, and we're not talking about large sums [in his personal portfolio]. He does these investments to amuse himself when he's not playing bridge."

"Even with the amount of money that Wesco has makes it very hard to play this game. You just have to have a prepared mind and be able to move rapidly."

" It took us months of buying all the Coke stock we could to accumulate $1 billion worth -- equal to 7% of the company. It's very hard to accumulate major positions."

Competitive advantages

"We don't have automatic competitive advantages. We're seeing some more insurance volume, mainly from General Re, and Cort and Precision Steel have momentum, but we have to find future advantages through our own intellect. We don't have enough critical mass and momentum in place at Wesco, so investors are betting on management."

"We have one slight edge that helps us: there's a lot of human love in building at least some businesses and some people who own businesses love them. They don't want to sell to a financial buyer who will dress it up and strip it down. When we buy a company, we don't tinker with winning businesses. So, for some sellers such as Justin, Berkshire Hathaway was the only acceptable buyer."

"If you want a culture like ours, I don't know anywhere to get it if not here. In that sense, we're stronger than we were years ago because we're better known. I don't think GE is going to catch us in this area."

"So, we may well have a competitive advantage buying decent businesses at decent prices. But they won't be fabulous businesses and fabulous prices. There's too much competition and money out there, with many buyout specialists. Debt is tight right now, which helps us. Berkshire wouldn't have been able to buy Johns Manville were it not for this."

Wesco's history
"Wesco had a market capitalization of $40 million when we bought it [in the early 1970s]. It's $2 billion now. It's been a long slog to a perfectly respectable outcome -- not as good as Berkshire Hathaway or Microsoft, but there's always someone in life who's done better."

Berkshire buying Wesco outright
"It's a historical accident [that Wesco is only 80.1% owned by Berkshire and that its stock continues to trade], due to complicated tax reasons. I suspect that it will eventually become wholly owned by Berkshire, but it's hard to do when you people maintain this enthusiasm [for the stock]."

Berkshire's future returns
"Warren said [at the Berkshire annual meeting] that he hoped to do modestly better than the market. 15% would be a hell of a number, so the target is the 6-15% range."

"You're in the same boat we are."

Buffett's decision making
"Warren is amazingly quick to say both yes and no."

Cort
"Cort will keep growing, both via acquisitions and expanding in its current markets. It will do pretty well. It's like Enterprise Rent-A-Car. They both have a terrific culture, service and incentive system."

"Cort has good relationships with its suppliers. Capitalism works better when there's trust in the system."

General Re
"It's one of the best reinsurance operations in the world. It has a strong distribution network and culture -- a culture of intelligence and discipline. It sees reinsurance opportunities that Berkshire doesn't. They have a huge advantage being there for so long. Gen Re's competitive advantage is that it's smarter and sees more opportunities."

"I don't think its returns in the future will be as good, but a 2-3%/year advantage is a lot over time."

"Reinsurance is interesting. A lot of people get into the business because of the money. Then, reinsurance brokers -- who are very well paid and can make dumb ideas look good

-- pitch them business. Boy, is this dangerous! Very smart people can make very dumb investments. Even GEICO and Gen Re get caught sometimes."

Insurance reserves
"In the past, we've under-reserved, but more often been overly conservative. Consequently, Berkshire and especially Wesco have been reversing some reserves."

Insuring against natural disasters
"No-one wanted to write California earthquake coverage [as Berkshire did]. We're like that."

"We don't think because it's never happened that it won't. There's no actuarial science, it's rough judgment. We just try to be conservative."

Wesco's and Berkshire's inefficient tax structure
"We don't have any miraculous way of avoiding taxes at Wesco and Berkshire. With float, we get some tax benefit."

[Munger said something about some of the most foolish behavior he's ever seen was a result of trying to avoid paying taxes.]

"What a terrible, inefficient thing it is to own real estate and securities in a Section C Corporation [like Wesco and Berkshire]. The enormous taxes we paid when we sold Freddie Mac last year is an example of this. If we were a partnership, you wouldn't have had to pay this. It's very hard."

"We drifted into this structure by accident. We bought a doomed textile mill [Berkshire Hathaway] and a California S&L [Savings & Loan; Wesco] just before a calamity. Both were bought at a discount to liquidation value. It turned out wonderful for many people in this room -- Wesco's market cap has grown from $40 million to $2 billion -- but it was dumb. The structure is terribly inefficient and bad. It's much better when we buy wholly owned businesses like Precision Steel."

Why not franchise See's candy stores?
"It takes almost no capital to open a new See's candy store. We're drowning in capital of our own that has almost no cost. It would be crazy to franchise stores like some capital-starved pancake house. We like owning our own stores as a matter of quality control."

Walter Scott, Level 3 Communications, and Berkshire's investment in electricity
"Walter Scott has one of the best business records ever. People put a lot of money in new fiber optic networks, and now there is a bloodbath that has driven Level 3 stock down. I don't think it means that Walter Scott is any less of a businessman."

"Berkshire's electricity investment [in Mid-American Energy] was in a total system in Iowa and a distribution system in Britain. It's doing perfectly fine. I would not extrapolate

these results to new capacity in a new field [such as Level 3]. Ours is a much more conservative investment."

"Electricity is a HUGE field. It's enormously stupid to run short of electricity. There's an opportunity to make reasonable returns and we're going to try."

Finova

"We're never done anything like this before, so there's no model. We think our offer is a good example for the creditors of Finova -- an honorable, intelligent transaction. It's fair to bondholders -- we're the largest -- and leaves some room for the stock to come back. It brings in good management with the right incentives. Of course there will be some complaints, but I'd be surprised if someone else comes in with the same offer."

"I wish every place in which we had a junk bond investment, someone came forward with an offer like ours."

Auto insurance pricing

"I think auto insurance is getting some rate increases. It was almost too good a business over the last 6-7 years."

Conservative nature

"We don't feel some compulsion to swing. We're perfectly willing to wait for something decent to come along."

"We're rich in relation to the business that we're doing."

Future returns from equities

"In certain periods, we have a hell of a time finding places to invest our money. We are in such a period."

"In Warren's *Fortune* article [11/22/99], he described the last two 18-year periods. During the first period, the market was essentially flat. The most recent one has been a marvelous period. Warren said that in the nature of things, double-digit returns couldn't go on and on and on. Therefore, individual shareholders and pension funds should reduce their expectations. My guess is that he'll be right for a long period ahead. There will be way lower returns over the next 15-18 years."

"The normal expectancy of the average investor -- for example, the pension funds of AT&T or IBM -- is 6% for a long time."

"With stocks yielding 1.5% and trading at 4-5x book value, it's not as much fun as it was buying Coke and Gillette at much lower prices relative to their valuations."

Recent stock market decline

"What you've recently seen is just a tea party. If you, like me, lived through 1973-74 or even the early 1990s… There was a waiting list to get OUT of the country club -- that's when you know things are tough. If you live long enough, you'll see it."

Purchase vs. pooling for acquisitions
"The problem is that the exact same transaction is treated differently. That's crazy. The proposal to require that all acquisitions be done using purchase accounting is perfectly reasonable. Berkshire made a mistake buying Dexter Shoes. When we found out, we wrote it down and took a charge against earnings. The difference is that we didn't say it was a one-time or unusual charge -- we just took it against earnings."

Retailing and Costco
"If I were teaching at business school, I'd take people through retailing because it's easy to understand. Retailing is pretty simple. There are four or five strategies."

"I'm a director of Costco. It's easy to understand. In the history of the world, few companies have succeeded on a 12% mark-up. They make it up with high volume. Costco has the right culture. They promote from within. It's a wonderful place to work."

"I think that Costco is a better operator in the warehouse club format than Sam's. Both companies will do well in the future, but I predict that Costco will do better."

"I don't know why schools don't teach this, but I'd teach a lot of things differently."

State Farm
"State Farm is one of the very richest insurance companies in the world. It's an honorable, old fashioned, high-grade place. They have integrity and skill. In condominium insurance, for example, they're the best. They're in Indiana, don't have elaborate compensation schemes, no stock options, and no high-falutin' advisors -- and they've blown by competitors. We admire them."

"They're enormously rich, so if they decide to keep a lid on auto insurance, I can't predict when they might stop. We [at GEICO] have a better model though."

Demutualization
"Are policy holders treated fairly [when an insurance company demutualizes]? The ordinary answer is 'No.' What a surprise."

How to detect bad reserving
"If [an insurance company's] combined ratio is wonderfully regular, then it's probably crooked. It's also a bad sign if a company is consistently under-reserving."

"Sometimes you can tell by the people that the numbers are good. For example, George Joseph of Mercury General is a genius and you know his numbers are right."

Wrigley

"Wrigley is a great business, but that doesn't solve the problem. Buying great businesses at advantageous prices is very tough."

Financial industry
"The financial industry has become so big. We keep pushing it further and further and further. For example, we now lease new autos for 36 months and guarantee a high residual value. How much further can you push consumer credit? We don't like it. We don't like pushing credit to extremes. We don't like daisy chain stock promotion. However, one of Berkshire's largest holdings is American Express, so we think it has a great future."

Medicare and HMOs
"The cost was projected to be X, but was actually 10X. People forgot that effects have effects. Incentives have super-effects. [Notes are sketchy here.] The original system was on a cost-plus basis. For example, a test was not reimbursed in a doctor's office, but was at a hospital, so doctors referred patients to the hospital to have the test. It was great for doctors and hospitals, but bad for patients and taxpayers."

"So then the system switched to DRGs [whereby providers were reimbursed a fixed amount for a certain disease/problem], which controlled costs somewhat. Then, there was a switch to HMOs, which did control costs. People who hate HMOs should realize that it was a needed response to a totally out of control system."

"Yes, HMOs have an incentive to deny needed care -- this kind of behavior is just unspeakable -- but no-one ever gives HMOs credit for preventing unnecessary, harmful procedures that doctors would otherwise do."

The decline of family-controlled businesses when family foundations take over
"Don't confuse correlation and causation. Almost all great records eventually dwindle. Those you mention [Reader's Digest, Kellogg] would have dwindled, even without family ownership."

"I think the foundation at Berkshire [Buffett's stake in Berkshire will pass to the Buffett Foundation upon his death] will be a plus because there will be a continuation of the culture. We'd still take in fine businesses run by people who love them."

Money managers
"We have a number of high-IQ individuals -- an enormous group compared to the past, 4-5 times as many -- devoting extraordinary time to beating the market. They have new vehicles: hedge funds, LBO funds, venture capital, international investing, etc. In the nature of things, some will succeed. But I don't think the mass of people's results, even pretty sound, glued-together people, will be very high."

"It's natural that you'd have more brains going into money management. There are so many huge incomes in money management and investment banking -- it's like ants to

sugar. There are huge incentives for a man to take up money management as opposed to, say, physics, and it's a lot easier."

"I think it's inevitable but terrible -- a disaster for the wider civilization. I'm somewhat ashamed… That I've profited from being shrewd with money is not by itself satisfying to me. To atone, I teach and try to set an example. I would hate it if the example of my life caused people to pursue the passive ownership of pieces of paper. I think lives so spent are disastrous lives. I think it's a better career if you help build something. I wish I'd built more, but I was cursed at being so good at stock picking. 'The man is the prisoner of his talents.' You can laugh, but I'll bet this room is full of people who are prisoners of their talents. It tends to be the human condition."

Asbestos litigation
"This is one of the most interesting things on the current scene. It affects you as both citizens and investors."

"Asbestos had many wonderful qualities. But when the health risks became clear, the companies that were major users of asbestos such as Johns Manville covered it up and were rightly hit with damages through the tort system. But other companies only used small amounts -- for example, in brake pads or a bit in USG's paste. Because of a tiny bit of asbestos in brake pads, Ford has set aside $1.7 billion to pay claims. There was a gain to society and the risk was low. It's not clear to me the damage from these uses."

"The claims bar quickly drove into bankruptcy anyone who behaved like Johns Manville, and then went after companies that didn't know they did anything wrong."

"The tobacco companies caused almost all of this."

"Now there is a whole class of people filing claims who have no symptoms. This accounts for way more than half the money being paid out. You could argue that it was a mistake to pay these claimants."

"It's coming from companies on an extortion basis. There are judges in Texas who are in the pockets of the plaintiff's bar, and there are compliant juries. It's turning the courts into an extortion system."

"Isn't it interesting that the only brand names that plaintiffs can remember are the brands of the only two solvent companies?"

"Is it good for society that lawyers, workmen, etc. are lying, that junk science is accepted? It's a national disgrace. I don't know where it will stop."

"I regard what's happening to USG as a dishonorable mugging of an honorable place. I don't think they should be driven out of business, but I don't want to make predictions about this."

"Is the system sound when obvious fraud goes on a massive scale? I would say no. And it spreads. You get what you reward for. That's why the claims keep coming and coming and coming. If you want ants, put sugar on the floor."

Later, another shareholder asked if he'd been too harsh on this topic. That set Munger off again:

"I wasn't harsh enough! Once you've got people benefiting from the system and use the money to influence judges and politicians [you've got a real mess]. It creates a situation that's very hard to fix. It would have been relatively easy to prevent if we'd had the will, but now it will be hell to fix. As Ben Franklin once said, 'An ounce of prevention is worth a pound of cure.'"

The decline of public schools

"There's a similar situation with schools. In Omaha years ago, there was an influx of poor minorities and white flight. It was obvious that Omaha Central High School was tipping toward 100% low-income minority students. If this happened, there would be no good high school in Omaha for minorities. This happened everywhere else. But in Omaha, a group of blacks demanded that there be an anti-black quota at Omaha Central, which passed and saved the school. It's a wonderful story, but the tragedy is that it only happened in Omaha."

"If you let it go, I don't see how you can reverse a lot of this stuff."

Estate tax

"Personally, I'm against the estate tax at its current rate, with its rapid rise to 55%. It hits owners of auto dealers, plumbers, etc. I think the exemption should be raised. [Since this appears likely to happen,] out of our crazy democratic system, we're going to get a reasonable outcome.

"I have no problem with this rate [for estates] in the hundreds of millions of dollars. I have no problem personally with the estate tax."

California energy crisis

"The California energy crisis is a disgrace -- to schools, executives, both political parties. There's enough disgrace to go around. We richly deserve this miserable result, which is due to extreme stupidity and indifference. [Quit beating around the bush, Mr. Munger. Tell us what you really think!] We are like the canary in a coal mine for other states, which are saying, 'Boy, have these guys done us a favor!' It's ABC basic what needs to be done: decrease pollution, increase conservation, and have the right incentives in the rates."

"In modern academia, there's no shame. People are taught Beowolf, but can't think their way out of a paper sack."

Investing abroad

"We don't feel any compulsion to go abroad because of any strategic considerations. We haven't taken the advice of any financial planner that I'm aware of. We have more comparative advantage buying in the U.S. because we're well known. There's no master plan. We're individual opportunity driven."

Mental models
"If you have the right mental equipment from the right education, you know it. We [at Berkshire and Wesco] have experienced people with the right models. You don't want to be the patient of a surgeon who's doing his first complicated procedure."

"My speech about mental models using Coke as an example was a failure. People had to read it two or three times before it sunk in, and even then it only sunk in if people already half knew it."

Prediction of interest rates
"Neither Warren nor I has ever made a dime in this area."

John Train
Asked to comment on John Train's books (The Money Masters, etc.), Munger said, "He's a gifted writer with moderate insights into the investment process."

Damn Right (biography of Munger by Janet Lowe)
"I didn't want it done. I felt that the disadvantages outweighed the advantages. I like to keep private. But once it became clear that she would write it with or without me, it was obviously the right decision to cooperate. I got to like Janet Lowe -- she's a very high-grade person. The book gave me the chance to spread some of my ideas without having to do the work. One idea is that whenever you think something or some person is ruining your life, it's you. A victimization mentality is so debilitating. I love spreading this stuff around. Just because it's trite doesn't mean it isn't right. In fact, I like to say, 'If it's trite, it's right.'"

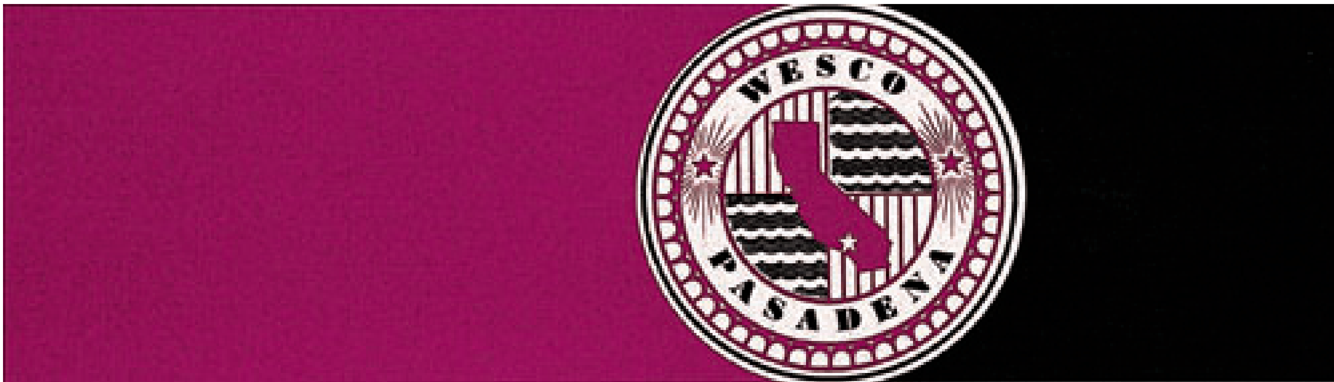
Munger's writings
"For you masochists, I taught a course at Stanford Law School recently and compiled some readings. Copies are available in boxes at the front of the room."

The booklet, privately printed by Munger, is entitled "Some Investment-Related Talks and Writings Made or Selected by Charles T. Munger." In it is:

1) "The Great Financial Scandal of 2003, An Account by Charles T. Munger." Unlike the other readings in this booklet, I don't believe this has ever been published before. It details a hypothetical financial scandal in 2003, triggered by dishonest accounting, especially for options, at an imaginary tech company called Quant Tech (which appears to be a bit of Cisco, IBM and the like).
2) "11/10/00 Talk of Charles T. Munger to Breakfast Meeting of the Philanthropy Round Table." Munger rails against --among other things -- "common-stock-price-

related 'wealth effects'" and foundations and other investors "wasting 3% of assets per year in unnecessary, nonproductive investment costs."

3) "Investment Practices of Leading Charitable Foundations, Speech of Charles T. Munger on October 14, 1998 to a meeting of the foundation financial officers group." Munger continues railing against the investment practices of foundations -- lessons that apply to nearly all investors. You can read it at http://www.tiff.org/pub/pages/othres.html?body=Munger_Speech.html.
4) "Mr. Buffett on the Stock Market," 11/22/99. A reprint of Buffett's *Fortune* magazine article, in which Buffett presciently warns investors about the tech bubble and argues that stock market returns for the foreseeable will be in the mid-single digits. You can read it at http://w3.res.ulaval.ca/cours-gsf-60808/buffet.html.
5) Munger's 1994 presentation to the USC Business School on "Investment Expertise as a Subdivision of Elementary, Worldly Wisdom." The transcript is from the 5/5/95 Outstanding Investor Digest. In this speech, Munger talks about the importance of mental models and argues that "you're got to hang experience on a latticework of models in your head" to be a successful investor and thinker.
6) A transcript of last year's Wesco annual meeting, published in the 12/18/00 edition of Outstanding Investor Digest. My notes from that meeting are available at http://www.fool.com/boringport/2000/boringport00051500.htm.



WESCO FINANCIAL CORPORATION

Annual Report 2001

Form 10-K Annual Report 2001

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated net ''operating'' income (i.e., before realized securities gains shown in the table below) for the calendar year 2001 decreased to $52,536,000 ($7.38 per share) from $70,087,000 ($9.84 per share) in the previous year.

Consolidated net income decreased to $52,536,000 ($7.38 per share) from $922,470,000 ($129.56 per share) in the previous year.

Wesco has four major subsidiaries: (1) Wesco-Financial Insurance Company (''Wes-FIC''), headquartered in Omaha and engaged principally in the reinsurance business, (2) The Kansas Bankers Surety Company (''KBS''), owned by Wes-FIC and specializing in insurance products tailored to midwestern banks, (3) CORT Business Services Corporation (''CORT''), headquartered in Fairfax, Virginia, purchased in February 2000 and engaged principally in the furniture rental business, and (4) Precision Steel Warehouse, Inc. (''Precision Steel''), headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended			
	December 31, 2001		December 31, 2000	
	Amount	Per Wesco Share[2]	Amount	Per Wesco Share[2]
Operating earnings:				
Insurance businesses	$45,254	$6.36	$ 45,518	$ 6.39
CORT furniture rental business	13,076	1.84	28,988	4.07
Precision Steel businesses	388	.05	1,281	.18
Goodwill amortization[3]	(6,814)	(.96)	(5,867)	(.82)
Other[4]	632	.09	167	.02
	52,536	7.38	70,087	9.84
Realized net securities gains	—	—	852,383	119.72
Wesco consolidated net income	$52,536	$7.38	$922,470	$129.56

(1) All figures are net of income taxes.

(2) Per-share data are based on 7,119,807 shares outstanding. Wesco has had no dilutive capital stock equivalents.

(3) In accordance with a new pronouncement of the Financial Accounting Standards Board, Wesco will no longer be required to amortize goodwill beginning in 2002. The requirement for such amortization has been replaced by a standard that requires an annual assessment to determine whether the value of goodwill has been impaired, at which time the intangible would be written down or written off, as appropriate.

(4) After deduction of interest and other corporate expenses, and costs and expenses associated with foreclosed real estate previously charged against Wesco's former Mutual Savings and Loan Association subsidiary. Income was from ownership of the Wesco headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the insurance subsidiaries.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The foregoing supplementary breakdown is furnished because it is considered useful to

shareholders. The total consolidated net income shown above is, of course, identical to the total in our audited financial statements.

Insurance Businesses

Consolidated operating earnings from insurance businesses represent the combination of the results of their insurance underwriting with their net investment income. Following is a summary of these figures as they pertain to all insurance operations except The Kansas Bankers Surety Company (''KBS''), which is separately discussed below.

	Pre-Tax Operating Earnings		After-Tax Operating Earnings	
	2001	**2000**	**2001**	**2000**
Underwriting loss	$(12,403,000)	$ (616,000)	$(8,062,000)	$ (400,000)
Net investment income	64,529,000	53,412,000	44,001,000	38,958,000
Operating income	$ 52,126,000	$52,796,000	$35,939,000	$38,558,000

As shown above, operating income includes significant net investment income, representing dividends and interest earned from marketable securities. However, operating income excludes realized net securities gains, net of income taxes, of $853.1 million in 2000. There were no such gains in 2001. Our discussion will concentrate on insurance underwriting, not on the results from investments.

Results for 2001 from insurance underwriting, other than at KBS, were the worst since we entered into the insurance business in 1985.

The nature of our non-KBS insurance business was roughly described in our year 2000 Annual Report wherein we reported to shareholders that we were not currently active in super-catastrophe reinsurance and had never suffered a super-catastrophe loss, but that shareholders should continue to realize that Wes-FIC's marvelous underwriting results were sure to be followed, sometime, by one or more horrible underwriting losses.

When we said that, we had in mind a natural catastrophe. But, instead, we were clobbered by a man-made catastrophe on September 11 — an event that delivered the insurance industry its largest loss in history. Fortunately, we recorded a loss of only $10 million, before income taxes ($6.5 million, after taxes) in connection with that event. The $10 million is an estimate and is subject to considerable estimation error. It will literally take years to resolve complicated coverage issues, as well as to develop an accurate estimation of insured losses that will ultimately be incurred. That $10 million, however, was the principal cause of our substantial underwriting loss in 2001.

At the end of 2001 we retained about $17 million in invested assets, offset by claims reserves, from our former reinsurance arrangement with Fireman's Fund Group. This arrangement was terminated August 31, 1989. However, it will take a long time before all claims are settled, and, meanwhile, Wes-FIC is being helped over many years by proceeds from investing ''float'' and by favorable loss development, which has enabled it to reduce the liability for losses and loss-related

expenses, benefiting after-tax operating earnings in 2001 and 2000 by $.8 million each.

We engage in other reinsurance business, including large and small quota share arrangements similar and dissimilar to our previous reinsurance contract with Fireman's Fund Group, and, from time to time, in super-cat reinsurance, described in detail in previous annual reports, which Wesco shareholders should re-read each year.

In almost all recent reinsurance sold by us, other subsidiaries of our 80%-owning parent, Berkshire Hathaway, sold several times as much reinsurance to the same customers on the same terms. In certain instances, such subsidiaries have taken from us a 3%-of-premiums ceding commission on premium volume passed through them to Wes-FIC. Excepting this ceding commission, Wes-FIC has had virtually no insurance-acquisition or insurance administration costs with regard to those policies.

KBS, purchased by Wes-FIC in 1996 for approximately $80 million in cash, contributed $9.3 million to the after-tax operating earnings of the insurance businesses in 2001 and $7.0 million in 2000. These figures are before goodwill amortization under accounting convention of $.8 million each year. The results of KBS have been combined with those of Wes-FIC, and are included in the table on page 1 in the category of ''insurance businesses.''

KBS was chartered in 1909 to underwrite deposit insurance for Kansas banks. Its offices are in Topeka, Kansas. Over the years its service has continued to adapt to the changing needs of the banking industry. Today its customer base, consisting mostly of small and medium-sized community banks, is spread throughout 27 mainly midwestern states. In addition to bank deposit guaranty bonds which insure deposits in excess of FDIC coverage, KBS also offers directors and officers indemnity policies, bank employment practices policies, bank annuity and mutual funds indemnity policies and bank insurance agents professional errors and omissions indemnity policies.

KBS increased the volume of business retained effective in 1998. It had previously ceded almost half of its premium volume to reinsurers. Now it reinsures only about 5% under arrangements whereby other Berkshire subsidiaries take 50% and unrelated reinsurers take the other 50%. As we indicated last year, the increased volume of business retained comes, of course, with increased irregularity in the income stream.

The combined ratio of an insurance company represents the percentage that its underwriting losses and expenses bear to its premium revenues. KBS's combined ratio has been much better than average for insurers, at 55.1% for 2001 and 73.9% for 2000, and we continue to expect volatile but favorable long-term effects from increased insurance retained.

KBS is ably run by Donald Towle, President, assisted by 15 dedicated officers and employees.

CORT Business Services Corporation (''CORT'')

In February 2000, Wesco purchased CORT Business Services Corporation (''CORT'') for $386 million in cash.

CORT is a very long established company that is the country's leader in rentals of furniture that lessees have no intention of buying. In the trade, people call CORT's activity ''rent-to-rent'' to distinguish it from ''lease-to-purchase'' businesses that are, in essence, installment sellers of furniture.

However, just as Hertz, as a rent-to-rent auto lessor in short-term arrangements, must be skilled in selling used cars, CORT must be and is skilled in selling used furniture.

CORT's revenues totaled $395 million for calendar 2001, versus $361 million for the ten months that we owned it in the year 2000. Of these amounts, furniture rental revenues were $329 million and $306 million, and furniture sales revenues were $66 million and $55 million. CORT contributed $13.1 million to Wesco's consolidated operating income for the entire year of 2001, versus $29.0 million for the ten months of 2000. These figures are before (1) goodwill amortization of $6.0 million for 2001 and $5.1 million for 2000, and (2) realized securities losses of $.7 million in 2000.

CORT's after-tax operating income (before goodwill amortization) for the entire calendar year 2000 was $33.4 million compared to only $13.1 million for 2001, a decline of 61%.

When we purchased CORT early in 2000, its furniture rental business was rapidly growing, reflecting the strong U.S. economy, phenomenal business expansion and explosive growth of IPOs and the high-tech sector. Beginning late in 2000, however, new business coming into CORT began to decline. With the burst of the dot-com bubble, continued weakness in the economy and the events of September 11, CORT's operations were hammered in 2001.

Moreover, CORT started up a new subsidiary during the year, Relocation Central Corporation, whose $12 million in expenses far exceeded its $1 million in revenues. The results of its operations have been consolidated with those reported for CORT, shown above. Relocation Central has developed a virtual call center which carries out an internet-based furniture and apartment leads operation (www.relocationcentral.com), and it has begun marketing CORT's furniture rental services to real estate investment trusts, owners of many major apartment communities. CORT is hopeful that, through Relocation Central, it will ultimately become the principal source of rental furniture to the apartment industry.

We hope to report in due course that all CORT operations have become more satisfactory, but prospects for 2002 do not thrill us. However, there is good news along with bad. CORT operates at a positive cash flow. During 2001 it reduced its line-of-credit debt by $32 million and invested an additional $20 million in business expansion through acquisitions of several small businesses. We happily tolerate a

poor part of the business cycle when we turn it to our advantage by expanding business through cash acquisition at sound prices. We continue to believe that CORT's operations will remain profitable in any likely recession-related decline in the rent-to-rent segment of the furniture business.

When Wesco paid $386 million for CORT, about 60% of the purchase price was attributable to goodwill, an intangible balance sheet asset.

Wesco's consolidated balance sheet now contains about $264 million in goodwill (including $27 million from Wesco's 1996 purchase of KBS). Wesco's reported earnings were reduced by about $7 million of mostly-non-tax-deductible amortization of goodwill for 2001 and $6 million for 2000. The Financial Accounting Standards Board has recently adopted a rule that will no longer require automatic amortization of acquired goodwill beginning in 2002. Thus, earnings we report in the future will more closely reflect microeconomic reality as we appraise it.

More details with respect to CORT are contained throughout this annual report, to which your careful attention is directed.

CORT has long been headed by Paul Arnold, age 55, who is a star executive as is convincingly demonstrated by his long record as CEO of CORT. We are absolutely delighted to have Paul and CORT within Wesco, are pleased with CORT's performance under his leadership, despite adverse developments in 2001, and we hope to see a considerable expansion of CORT's business and earnings in future years.

Precision Steel Warehouse, Inc. ("Precision Steel")

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, contributed $.4 million to Wesco's net operating earnings in 2001, down from $1.3 million in 2000 and $2.5 million in 1999. Had it not been for LIFO inventory accounting adjustments, Precision Steel would have reported no income at all for the year 2001, versus $1.7 million, after taxes, for 2000.

Last year we reported that the U.S. steel industry was generally a disaster in 2000, and that Precision Steel suffered worse effects than occurred for it in previous general declines in the U.S. steel business. The year 2001 was much worse. The absence of Precision Steel's operating earnings for 2001, before the effect of the LIFO adjustment, was due principally to a significant reduction in demand for steel, combined with intensified competition above the fierce level encountered in the prior year. This resulted in a 29.7% decrease in pounds of product sold. Sales revenues declined 25.6%.

We do not regard earnings changes from LIFO accounting adjustments, up or down, as material in predicting future earning power.

Terry Piper, who became Precision Steel's President and Chief Executive Officer late in 1999, has done an excellent job in leading Precision Steel through difficult years.

Tag Ends from Savings and Loan Days

All that now remains outside Wes-FIC but within Wesco as a consequence of Wesco's former involvement with Mutual Savings, Wesco's long-held savings and loan subsidiary, is a small real estate subsidiary, MS Property Company, that holds tag ends of real estate assets with a net book value of about $5.8 million, consisting mainly of the nine-story commercial office building in downtown Pasadena, where Wesco is headquartered. MS Property Company's results of operations, immaterial versus Wesco's present size, are included in the breakdown of earnings on page 1 within ''other operating earnings.''

Other Operating Earnings

Other operating earnings, net of interest paid and general corporate expenses, amounted to $.6 million in 2001 and $.2 million in 2000. Sources were (1) rents ($3.2 million gross in 2001) from Wesco's Pasadena office property (leased almost entirely to outsiders, including California Federal Bank as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiaries, less (3) general corporate expenses plus minor expenses involving tag-end real estate.

Realized Net Securities Gains

The main tag end from Wesco's savings and loan days was an investment in Freddie Mac common stock, purchased by Mutual Savings for $72 million at a time when Freddie Mac shares could be lawfully owned only by a savings and loan association. Those shares, carried on Wesco's balance sheet at yearend 1999 at a market value of $1.4 billion, were sold in 2000, giving rise to the principal portion of the $852.4 million of after-tax securities gains realized by Wesco in 2000, versus no gains or losses realized in 2001.

Although the realized gain had a material impact on Wesco's reported earnings for 2000, *it had a very minor impact on Wesco's shareholders' equity*. Inasmuch as the greater portion of the realized gain had previously been reflected in the unrealized gain component of Wesco's shareholders' equity, the amount was merely switched from unrealized gains to retained earnings, another component of shareholders' equity.

Consolidated Balance Sheet and Related Discussion

As indicated in the accompanying financial statements, Wesco's net worth, as accountants compute it under their conventions, decreased to $1.91 billion ($269 per Wesco share) at yearend 2001 from $1.98 billion ($278 per Wesco share) at yearend 2000.

The foregoing $269-per-share book value approximates liquidation value assuming that all Wesco's non-security assets would liquidate, after taxes, at book value. Perhaps this assumption is too conservative. But our computation of liquidation value is unlikely to be too low by any large percentage because (1) the liquidation

value of Wesco's consolidated real estate holdings (where interesting potential now lies almost entirely in Wesco's equity in its office property in Pasadena containing only 125,000 net rentable square feet), and (2) possible unrealized appreciation in other assets cannot be large enough, in relation to Wesco's overall size, to change very much the overall computation of after-tax liquidating value.

Of course, so long as Wesco does not liquidate, and does not sell any appreciated securities, it has, in effect, an interest-free ''loan'' from the government equal to its deferred income taxes on the unrealized gains, subtracted in determining its net worth. The sale of the Freddie Mac shares in 2000 was principally responsible for the reduction of that interest-free ''loan'' from $705 million as of yearend 1999 to $199 million as of yearend 2001. This interest-free ''loan'' from the government is at this moment working for Wesco shareholders and amounted to about $28 per Wesco share at year end 2001.

However, some day, additional parts of the interest-free ''loan'' may be removed as securities are sold, as happened to such a large extent with the sale of Freddie Mac stock in 2000. Therefore, Wesco's shareholders have no perpetual advantage creating value for them of $28 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than $28 per Wesco share.

Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway. Moreover, the quality disparity in book value's intrinsic merits has, in recent years, continued to widen in favor of Berkshire Hathaway.

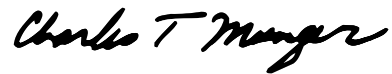
All that said, we make no attempt to appraise relative attractiveness for investment of Wesco versus Berkshire Hathaway stock at present stock-market quotations.

To progress from this point at a satisfactory rate, Wesco plainly needs more favorable investment opportunities, recognizable as such by its management, preferably in whole companies like CORT, but, alternatively, in marketable securities to be purchased by Wesco's insurance subsidiaries.

The thing that should interest Wesco shareholders most with respect to 2001 is that we found no new common stocks for our insurance companies to buy. We are not excited by general prospects for common stocks.

The Board of Directors recently increased Wesco's regular dividend from 31½ cents per share to 32½ cents per share, payable March 6, 2002, to shareholders of record as of the close of business on February 6, 2002.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.



Charles T. Munger
Chairman of the Board

March 5, 2002

Notes from the 2002 Wesco annual meeting, 5/8/02

By Whitney Tilson

COMMENTS ON BERKSHIRE HATHAWAY AND WESCO

Berkshire's competitive advantages in reinsurance
"I do think we get some advantage in reinsurance because people trust our willingness and ability to pay, so it's not a commodity. I think we have some special talents. That being said, I think it's dangerous to rely on special talents -- it's better to own lots of monopolistic businesses with unregulated prices. But that's not the world today. We have made money exercising our talents and will continue to do so."

"I'm glad we have insurance, though it's not a no-brainer, I'm warning you. We have to be smart to make this work."

Outlook for Berkshire's insurance operations
"The overall result is that we're going to do pretty well -- meaning in the top 10% [of the industry] -- because we do different things. In New Jersey, when they capped rates, we said we were going to withdraw from the market, and we did. We're one of the only corporations in America to run off its derivative book. We had hoped to sell it, but that didn't work out. We're willing to do some unpleasant things."

"Generally speaking, we're mildly optimistic about our insurance operations." [This is Munger-speak for "I'm quite enthusiastic about our insurance operations."]

Berkshire's future outlook
"It's a finite and very competitive world. All large aggregations of capital eventually find it hell on earth to grow and thus find a lower rate of return."

"Personally, I think Berkshire will be a lot bigger and stronger than it is. Whether the stock will be a good investment from today's price is another question. The one thing we've always guaranteed is that the future will be a lot worse than the past."

Types of businesses Berkshire buys
"A lot of things we do are fairly basic. Bricks have been around since Babylon. Their consumption is regular and predictable. Our brickyards dominate their region."

"We tend to buy things -- a lot of things -- where we don't know exactly what will happen, but the outcome will be decent."

Would Berkshire ever invest in Level 3?
"We have the same problem as everyone else: it's very hard to predict the future [of Level 3]. Could we invest in it? Sure, it's conceivable. After all, we're in the electricity distribution business in the UK and the generating and distribution business in Iowa. We have a history when things are really horrible of wading in when no-one else will."

Berkshire's culture
"Berkshire's culture could go on for a long, long time because we've decentralized power to people who deserve it."

"For many of our shareholders, our stock is all they own, and we're acutely aware of that. Our culture [of conservatism] runs pretty deep."

Share price
"We don't like our stocks [Berkshire and Wesco] to get too high -- only deservedly high -- so we tend to throw deserved bits of cold water on them. For example, in the prospectus for the Berkshire B shares, we said we wouldn't advise anyone to buy our stock. People bought it anyway, but we tried to dampen it."

Share buybacks
"If only you people thought a lot less of us, there would be more opportunity to buy back Wesco and Berkshire shares."

Bonds
"Berkshire owns bonds in two ways:

1) Through our insurance operations. Mainly mortgage backed, with some government and a little junk.

2) Through our finance subsidiary. Interesting little things. I call it the 'miscellaneous Warren Buffett account.' As long as he's doing it, I'm OK with it. We've made a few hundred million [dollars] with little risk or fuss."

Comments on Wesco
"Wesco's insurance operations are decent, but small."

"Wesco's business has come up some in the past year or two."

Berkshire's insurance accounting
"Generally speaking, we think we're more conservative than most insurers. Nevertheless, in certain periods, we've discovered that our reserves were not adequate. But over time, we'll not only try to be more conservative, we will be."

Will Berkshire be in the S&P 500?
"If Berkshire were owned by institutions, it would already be in the S&P 500. But Berkshire's loyal shareholders would cause a price spike if it were added to the S&P 500 [because of all the index funds that would have to buy the stock], which would be an embarrassment. Sooner or later it will be in, but not tomorrow."

History of Buffett's investing philosophy
"Warren Buffett came to investing at the knee of Ben Graham, who ran a Geiger counter over the detritus of the 1930s. Stocks were ridiculously cheap. Graham bought companies that were quite mediocre on average, but made 20% when their stock bounced."

"Warren trained under this system and made money, so he was slower to come to the idea I learned that the best way to make money is to buy great businesses that earn high returns on capital over long periods of time."

"We're applying Graham's basic ideas, but now we're trying to find undervalued GREAT companies. That concept was foreign to Ben Graham."

"Warren would have morphed into a great investor without Ben Graham. He is a greater investor than Graham was. Warren would have been great had he never met anyone else. He would have excelled at any field that required a high IQ, quantitative skills and risk taking. He wouldn't have done well at ballet though."

Differences between Buffett, Munger and Simpson
"Not very much."

[Lou Simpson, who manages GEICO's investment portfolio, was in the audience, so Munger asked him to address this question. He said:] "The big difference between you and Warren and my situation is the difference is size. We're $2.5 billion, whereas you and Warren are many times more, so we have an advantage in looking at smaller situations. If we find a $200-$250 million position, we can invest and make a difference."

Munger: "It does make a difference. Maybe Lou is just smarter. His returns have been better [over the past few years]."

COMMENTS ON BERKSHIRE HATHAWAY HOLDINGS

Gen Re
"Gen Re misguessed its reserves -- almost every insurer in America did -- which is why we took a big loss."

"Gen Re always tried to do it right [reserve properly]. Losses crept up on everybody. You'd think that under Berkshire, their reserving, which was always very good, would be more conservative, consistent with Berkshire's culture."

"At Warren's level, we operate through the CEO of Gen Re, who has to tinker with the culture. It's a good culture, but with the world so tough, we need to improve it a bit."

Munger's role in the purchase of Gen Re
"That thing was very far along before I ever heard of it. There will be more of this as the years go on."

Finova
"Finova is a run-off situation. It's not going to run off as well as it would have before 9/11 happened, but it will work out fine. We'll make hundreds of millions. It's a blip in the history of Berkshire."

American Express
"American Express has had some things that didn't work out. Am I satisfied by what we know at American Express? Yes. We never expected them to handle their investments the way we'd handle ours. But we're big boys. We're not depressed about American Express."

USG
"[Our investment in] USG obviously hasn't worked out very well. It wasn't just asbestos -- the market for wallboard went to hell. We missed that too. What can I say? It reminds me of a story about a man who had a wife and three kids. He conceived an illegitimate child with a woman he'd just met. When asked why he did it, he said, 'It seemed like a good idea at the time.'"

INVESTMENT ADVICE

Becoming a good investor
"If you're going to be an investor, you're going to make some investments where you don't have all the experience you need. But if you keep trying to get a little better over time, you'll start to make investments that are virtually certain to have a good outcome. The keys are discipline, hard work and practice. It's like playing golf -- you have to work on it."

Investing mental models
"You need a different checklist and different mental models for different companies. I can never make it easy by saying, 'Here are three things.' You have to derive it yourself to ingrain it in your head for the rest of your life."

Circle of competence
"There are a lot of things we pass on. We have three baskets: in, out and too tough. A lot of stuff goes into the 'too tough' basket. We can't do that if it's a problem at a Berkshire subsidiary company, but if we don't own it, we just pass."

"I don't know how people cope [trying to figure everything out]."

"We have to have a special insight, or we'll put it in the 'too tough' basket. All of you have to look for a special area of competency and focus on that."

Buying into stock declines
"Over many decades, our usual practice is that if [the stock of] something we like goes down, we buy more and more. Sometimes something happens, you realize you're wrong, and you get out. But if you develop correct confidence in your judgment, buy more and take advantage of stock prices."

COMMENTS ON VARIOUS COMPANIES, INDUSTRIES AND OTHER ECONOMIC MATTERS

Freddie Mac

"We held that stock for a great many years, and of course made a great deal of money."

"Warren and I get nervous with vast amounts of leverage unless we're 100% confident that risk-taking won't creep into the culture."

"It reminds me of a guy running a company who fired his top producer. The guy asked him, 'Why are you firing me? I'm your top producer.' To which he responded, 'You make me nervous. I'm a rich old man. Why should I be nervous?"

Lloyd's

"At present, Lloyd's is greatly improved. Lloyd's had become a sewer. Ethics became terrible, easy money, three-hour lunches with drinks... The culture got quite bad and it degenerated into huge underwriting losses."

"It's way better now, but not totally reformed. The jury's still out."

Moody's

"Most of the bonds Berkshire buys, Warren picks. He doesn't need Moody's, nor does he look at their rating. But he believes Moody's provides a useful service."

Influence of board members (or lack thereof)

"Joe Rosenfeld -- a marvelous human being and great friend -- was asked to be on the board of Northwestern Bell. He said it was the last thing they ever asked him. That's typical. Sometimes a CEO asks for advise when a board has expertise, but they generally make their own decisions and use their staff. Averaged out, the CEO decides what he wants to do and the board says yes."

"We have very little influence [on the boards Warren and I serve on]. There's an occasional exception if someone has very high regard for us."

Risks of financial institutions

"The beauty of a financial institution is that there are a lot of ways to go to hell in a bucket. You can push credit too far, do a dumb acquisition, leverage yourself excessively -- it's not just derivatives [that can bring about your downfall]."

Consumer credit

"My method for a nation growing is Germany after World War II -- no consumer credit, but high growth."

"In the U.S. today, we push consumer credit harder year after year. There are occasional blow-ups like Providian. Could we have a big national blow-up? Yes. It tends to be self-correcting."

"Once you get used to growing each year by goosing consumer credit 5%, what do you do when you've reached the limit?"

"I don't like it. I don't like thinking up ads to get people to use their credit card more. But it's not illegal and maybe the world's even better for it. It's not my temperament though."

The wealth effect
"The wealth effect is the extent to which consumer spending is goosed upward due to increases in stock prices. Of course it exists, but to what extent? I made a speech a while back in which I said that the wealth effect is greater than economists believe. I still say this."

"The wealth effect is one driver of economic assumption, but not the only one. The government in two years has gone from back-to-back surpluses to increasing spending 10% each year. Also, the decline in interest rates has led to an increase in housing values, which makes people feel richer. So, there are countervailing effects."

"Look at Borsheim's. When Level 3 [a widely held stock in Omaha] crashed 97%, there was a big effect [on Borsheim's sales]. There are also more homes for sale [in Omaha]."

"So many people try to predict macroeconomic factors by looking at only one factor. You need to look at all the factors."

Risk of the unexpected
"A lot of things happen that you can't predict. Who would have predicted the war on terrorism, government spending increasing 10% each of the past two years, etc.?"

"We try to run our companies so there's no chance of going back to Go. I think we're way more aware of that possibility [the risk of going back to Go], but that's no guarantee [that it can't happen to us]. In our insurance underwriting, we put in more clauses [limiting our risk] and are more aware of aggregate risks."

Expect the unexpected (Japan example)
"Warren has said that over 40 years, a lot of surprising things will happen."

"What's interesting in Japan is that every life insurance company is essentially insolvent because they promised to pay 3%. Who'd have thought that this could lead to insolvency, but interest rates went to zero and stayed there for years. They tried to invest in equities, but got negative returns. Can you imagine 13 years with negative equity returns and interest rates below 1%?"

"Is it inconceivable that it could ever happen here? I don't think so. Strange things happen."

CRITIQUES OF ACCOUNTANTS AND INVESTMENT BANKERS

Wall Street's ethics (or lack thereof)
"Generally speaking, ethics on Wall Street have been imperfect throughout my lifetime. In the old days, brokers would sell old ladies very conservative utility stocks with a big mark-up."

"Underwriting standards were better then. Now, what can be sold, will be sold. It's terrible."

"With First Boston, under the Mellons, there are just some things they wouldn't do."

"It's always hard. Some guy needs to pay his kid's tuition and at the end of the month, let's say he's behind on his quota and there's Suzi's account. Lo and behold, there's some activity."

"The ethics of Wall Street will always average out to mediocre at best."

"I don't think you get a lot of credit in life for not committing adultery with the Virgin Mary."

"Analysts as shills were always present, but it reached extremes in the dot-com boom because there was so much money at stake. Wall Street firms can't make money trading stocks for two cents per share, but can make so much money doing deals."

"If you set up incentives to reward A, and then say you want B, you'll give people schizophrenia."

"This doesn't mean there aren't some wonderful, intelligent people on Wall Street -- there are, like those in this room -- but everyone I know has to fight their own firm [to do the right thing]."

Critique of legal and accounting firms
"I think there's plenty wrong with the legal profession. Plenty of law firms take business they shouldn't. Accounting has this problem in spades. All have clients they shouldn't have. All the leading law and accounting firms aren't quick enough to decline or kick out bad clients."

"Too many law and accounting firms get roped into shady things. For example, tax shelters, with their contingency fees and secrecy, are a total abomination. The troubles are contagious -- they spread."

"Lawyers have gotten away with murder. The rule of thumb now is to defend anyone, using any means, and not get sued. This is changing however. Now, people are being more careful. This tendency to pull back is good."

"I never have the least interest in defending miscreants and helping them misbehave. But the general view is that it's wonderful what Johnny Cochran did."

"They say the second-happiest day for a defense lawyer is winning an acquittal of an innocent man."

Derivatives
"Originally, there were interest rate swaps. If you did them naked, you could lose or make an enormous amount. But there wasn't enough money for traders, so they adopted mark-to-market accounting. Everyone caved, adopted loose [accounting] standards and created exotic derivatives linked to theoretical models. As a result, all kinds of earnings, blessed by

accountants, are not really being earned. When you reach for the money, it melts away. It was never there."

"The accountants have written 800 pages of rules on this."

"If you're the least bit venal, you can do what Enron did. Even if you're not, your employees will still [get you in trouble with derivatives]."

"It [accounting for derivatives] is just disgusting. It is a sewer, and if I'm right, there will be hell to pay in due course. All of you will have to prepare to deal with a blow-up of derivative books. To me, it's always been obvious it [the accounting for derivatives] is ridiculous."

"It's a crazy idea for people who are already rich -- like Berkshire -- to be in this business. It's a crazy business for big banks to be in."

[On this topic, here's an excerpt from the 5/20/02 Business Week:

"Critics say FASB's nitpicking hit bottom with Financial Accounting Standard No. 133, which governs accounting for financial derivatives and hedging. Launched in 1992, the standard is based on a simple principle: Futures, swaps, options, and other derivatives should be carried on books at their market value. But revaluing derivatives every quarter can create wide and unpredictable swings in corporate earnings. To avoid that, FASB carved out exceptions for hedging deals, forward contracts for materials, insurance policies, and other special cases. 'The exceptions are legitimate,' says FASB member John M. 'Neel' Foster, 'but once you start down that path, it's hard to stop.' The result: FAS 133 and its supporting documents weigh in at 800 pages--and it's still a work in progress."]

COMMENTS ON EDUCATION AND PROPER THINKING

Fooling oneself
"The ethos of not fooling yourself is one of the best ethoses you could possibly have. It's powerful because it's so rare."

Mental models
"Generally speaking, you need to have appropriate mental models and a checklist to go through each of them. If 2-3 items are not on the checklist, and you're a pilot, you might crash."

"It [this approach] is perfectly obvious. But how many of you were taught to think this way at university?"

[One person in a room of perhaps 200 raised his hand and, when asked which university he attended, said "MIT."]

Munger snorted and said: "This wasn't rehearsed. This underscores the importance of science. If you have kids or grandkids, make them take science [classes]. Can you imagine the kind of nonsense we'd get from the head of the poetry department at Amherst?"

Personal computer use
"Do I use a computer? Not so far. I just had a computer installed, but so far it's dark. I don't every type. As for the future? We'll see."

"I'm a big follower of Thomas Hunt Morgan [in 1933, he won the Nobel Prize in Physiology or Medicine]. While at Cal Tech, he banned the Frieden calculator, which everyone used for all sorts of calculations. Why? I walk along the river and pick up gold. So why should I do placer mining? I'm willing to do placer mining if need be, but I'm hoping to go to my grave without doing so."

"Organized common (or uncommon) sense -- very basic knowledge -- is an enormously powerful tool. There are huge dangers with computers. People calculate too much and think too little."

Importance of science
"I think scientific literacy is terribly important…Habits of the mind formed from science are so valuable."

"I once spoke at one of New York's great Catholic girls schools, and they require every student to take physics."

"Even if you're not a scientist, you can pick up on the big ideas like thermodynamics. A lot of people haven't bothered to learn thermodynamics, and that's a big mistake. I recall a utility that invested in a scheme to create energy from seawater. [Anyone with even a rudimentary knowledge of science would know that] this violates the laws of thermodynamics."

Inner-city schools
"Center-city school systems are a disaster. The schools are dealt a difficult hand, but many schools have shown not an impossible one."

Universities
"There's a lot wrong [with American universities]. I'd remove 3/4 of the faculty -- everything but the hard sciences. But nobody's going to do that, so we'll have to live with the defects. It's amazing how wrongheaded [the teaching is]. There is fatal disconnectedness. You have these squirrelly people in each department who don't see the big picture."

"This doesn't just happen in academia. Companies can get balkanized. Look at what happened at Arthur Andersen and Enron. They weren't all bad people, but their cultures were dysfunctional. It's easy to create such a culture, in which you have good people but terrible results. Many areas of government are dysfunctional. Universities are complicit. They don't feel guilty about the product they're producing."

"We have the best universities in the world. They are strong in the hard sciences, but if you go to business, law, sociology…"

ADVICE ON LIFE AND OTHER

Terrorism risk and immigration policy
"Our handling of the terrorism risk has been insanely sloppy. Can you imagine that someone with an Arabic name, who was Arabic looking, took lessons on flying big jets in which he didn't want to learn how to take off or land, and no-one asked any questions?! But it's the human condition. It's what bureaucracies do."

"I would be in favor of foolproof national identity cards, and wouldn't worry about due process with immigrants -- I'd really be more rigorous. But we're a democracy, and we'll muddle through."

"Canada's [immigration policies are] worse. They should have a banner that says, 'Welcome Terrorists!'"

"It's sad that we need an event like 9/11 to wake up."

Books
"Ice Age [only available in the UK; will be published in the U.S. later this year] is one of the best books I've ever read. I've spent thousands of dollars buying copies for my friends. If you don't like Ice Age, then you have some limitations."

"I also recommend How the Scots Invented the Modern World: The True Story of How Western Europe's Poorest Nation Created Our World and Everything in It. It's amazing how one million poor people with a lousy climate and no resources had such a large and constructive influence on the world. I tried to figure it out and couldn't. This professor did that. It's a wonderful book."

WESCO FINANCIAL CORPORATION

Annual Report 2002

Form 10-K Annual Report 2002

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated net income for the calendar year 2002 was $52,718,000 ($7.40 per share), essentially the same as $52,536,000 ($7.38 per share) in the previous year.

Wesco has four major subsidiaries: (1) Wesco-Financial Insurance Company (''Wes-FIC''), headquartered in Omaha and engaged principally in the reinsurance business, (2) The Kansas Bankers Surety Company (''KBS''), owned by Wes-FIC and specializing in insurance products tailored to midwestern banks, (3) CORT Business Services Corporation (''CORT''), headquartered in Fairfax, Virginia and engaged principally in the furniture rental business, and (4) Precision Steel Warehouse, Inc. (''Precision Steel''), headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[(1)]:

	Year Ended			
	December 31, 2002		December 31, 2001	
	Amount	Per Wesco Share[(2)]	Amount	Per Wesco Share[(2)]
Operating earnings:				
Insurance businesses	$49,471	$6.95	$45,254	$6.36
CORT furniture rental business	2,442	.34	13,076	1.84
Precision Steel businesses	250	.03	388	.05
Goodwill amortization[(3)]	—	—	(6,814)	(.96)
Other[(4)]	555	.08	632	.09
Wesco consolidated net income[(3)]	$52,718	$7.40	$52,536	$7.38

(1) All figures are net of income taxes.

(2) Per-share data are based on 7,119,807 shares outstanding. Wesco has had no dilutive capital stock equivalents.

(3) In accordance with a new pronouncement of the Financial Accounting Standards Board, Wesco discontinued goodwill amortization at the beginning of 2002. The requirement for such amortization has been replaced by a standard that requires an annual assessment to determine whether the value of goodwill has been impaired, at which time the intangible would be written down or written off, as appropriate. Had the new accounting standard been in effect for 2001, Wesco would have reported after-tax income of $59,350,000 or $8.34 per share, exclusive of goodwill amortization. **Thus, Wesco's 2002 after-tax net income, on a pro forma basis, actually *decreased* in 2002 by $6,632,000, or $.94 per share.**

(4) Represents income from ownership of the Wesco headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the insurance subsidiaries, less interest and other corporate expenses.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The foregoing supplementary breakdown is furnished because it is considered useful to shareholders. The total consolidated net income shown above is, of course, identical to the total in our audited financial statements.

Insurance Businesses

Consolidated operating earnings from insurance businesses represent the combination of the results of their insurance underwriting with their net investment income. Following is a summary of these figures as they pertain to all insurance operations except The Kansas Bankers Surety Company (''KBS''), which is separately discussed below.

	Pre-Tax Operating Earnings		After-Tax Operating Earnings	
	2002	2001	2002	2001
Underwriting gain (loss)	$ 92,000	$(12,403,000)	$(1,926,000)	$(8,062,000)
Net investment income	64,484,000	64,529,000	44,030,000	44,001,000
Operating income	$64,576,000	$ 52,126,000	$42,104,000	$35,939,000

As shown above, operating income includes significant net investment income, representing dividends and interest earned from marketable securities. Our discussion will concentrate on insurance underwriting, not on the results from investments.

Results for 2002 from insurance underwriting, other than at KBS, were sharply improved from those for 2001. Results for 2001 were the worst since we entered the insurance business in 1985. Results for 2002 were satisfactory.

The nature of our non-KBS insurance business was roughly described in our year 2000 Annual Report wherein we reported to shareholders that we were not currently active in super-catastrophe reinsurance and had never suffered a super-catastrophe loss, but that shareholders should continue to realize that Wes-FIC's marvelous underwriting results were sure to be followed, sometime, by one or more horrible underwriting losses.

When we said that, we had in mind a natural catastrophe. But, instead, in 2001 we were clobbered by a man-made catastrophe on September 11 — an event that delivered the insurance industry its largest loss in history. Fortunately, we recorded a loss of only $10 million before income taxes ($6.5 million, after taxes) in connection with that event. The $10 million is an estimate and is subject to considerable estimation error. It will literally take years to resolve complicated coverage issues, as well as to develop an accurate estimation of insured losses that will ultimately be incurred. That $10 million, however, was the principal cause of our substantial underwriting loss in 2001.

At the end of 2002 we retained about $15 million in invested assets, offset by claims reserves, from our former reinsurance arrangement with Fireman's Fund Group. This arrangement was terminated August 31, 1989. However, it will take a long time before all claims are settled, and, meanwhile, Wes-FIC is being helped over many years by proceeds from investing ''float'' and by favorable loss development, which has enabled it to reduce the liability for losses and loss-related expenses, benefiting after-tax operating earnings in 2002 and 2001 by $.8 million each year.

We engage in other reinsurance business, including large and small quota share arrangements similar and dissimilar to our previous reinsurance contract with Fireman's Fund Group, and, from time to time, in super-cat reinsurance, described in detail in previous annual reports, which Wesco shareholders should re-read each year.

Following is a summary of Wes-FIC's current reinsurance activity:

- A three-year arrangement entered into in 2000 through an insurance subsidiary of Berkshire Hathaway, our 80%-owning parent, as intermediary without ceding commission, for participation to the extent of 3.3% in certain property and casualty exposure ceded by a large, unaffiliated insurer. The terms of this arrangement are identical to those accepted by that Berkshire subsidiary except as to the amount of the participation.
- Participation in four risk pools managed by a Berkshire insurance subsidiary (also acting as intermediary without ceding commission) covering hull, liability, workers' compensation and satellite exposures relating to the aviation industry as follows: with respect to 2001, to the extent of 3% for each pool; for 2002, 13% of the hull and liability pools, 3% of the workers' compensation pool and, effective mid-year, 15.5% of the satellite pool; and, for 2003, 10% of the hull and liability pools only. The Berkshire subsidiary provides a portion of the reinsurance protection to these aviation risk pools, and therefore to Wes-FIC.

In much reinsurance sold by us, other Berkshire subsidiaries sold several times as much reinsurance to the same customers on the same terms. In certain instances but not always, such subsidiaries have taken from us a 3%-of-premiums ceding commission on premium volume passed through them to Wes-FIC. Excepting this ceding commission, Wes-FIC has had virtually no insurance-acquisition or insurance administration costs.

KBS, purchased by Wes-FIC in 1996 for approximately $80 million in cash, contributed $7.4 million to the after-tax operating earnings of the insurance businesses in 2002 and $9.3 million in 2001. The 2001 figure is before goodwill amortization of $.8 million; there was no goodwill amortization for 2002. Prior to 2002 goodwill was amortized mainly on a straight-line basis over 40 years. As explained above, as of the beginning of 2002, Wesco discontinued amortization of goodwill and became subject to other changes in goodwill accounting, as required by the Financial Accounting Standards Board. The results of KBS have been combined with those of Wes-FIC, and are included in the table on page 1 in the category of "insurance businesses."

KBS was chartered in 1909 to underwrite deposit insurance for Kansas banks. Its offices are in Topeka, Kansas. Over the years its service has continued to adapt to the changing needs of the banking industry. Today its customer base, consisting mostly of small and medium-sized community banks, is spread throughout 27 mainly midwestern states. In addition to bank deposit guaranty bonds which insure deposits

in excess of FDIC coverage, KBS offers directors and officers indemnity policies, bank employment practices policies, bank annuity and mutual funds indemnity policies, and bank insurance agents professional errors and omissions indemnity policies. Also, KBS has recently begun offering Internet banking catastrophe theft insurance.

Beginning in 2003, KBS revised the allocation of its reinsurance between a Berkshire insurance subsidiary and a non-affiliate: Under the previous program, the Berkshire subsidiary and the non-affiliate each reinsured 50% of the per-occurrence risks of $3 million in excess of $2 million, and the non-affiliate also reinsured 70% of the per-occurrence risks up to $10 million above $5 million, all for approximately 5% of KBS's premiums. Beginning in 2003, the Berkshire subsidiary has replaced the non-affiliate on the second layer, and total reinsurance costs are expected to aggregate 10%-12% of premiums. Reinsurance costs have risen greatly throughout the insurance industry, and the revised arrangement is considered fair by all involved, all factors considered. (Indeed, we believe that our combined insurance arrangements through Berkshire constitute a net advantage to Wes-FIC that would not be available from Berkshire in the absence of its 80% ownership of Wesco, and such combined insurance arrangements have worked out well so far, even after taking into account our September 11 loss in 2001.)

KBS increased the volume of business retained effective in 1998. It had previously ceded almost half of its premium volume to reinsurers. Now it reinsures only about 5%. As we indicated last year, the increased volume of business retained comes, of course, with increased irregularity in the income stream.

The combined ratio of an insurance company represents the percentage that its underwriting losses and expenses bear to its premium revenues. KBS's combined ratio has been much better than average for insurers, at 71.3% for 2002 and 55.1% for 2001, and we continue to expect volatile but favorable long-term effects from increased insurance retained.

KBS is ably run by Donald Towle, President, assisted by 15 dedicated officers and employees.

CORT Business Services Corporation ("CORT")

In February 2000, Wesco purchased CORT Business Services Corporation ("CORT") for $386 million in cash.

CORT is a very long established company that is the country's leader in rentals of furniture that lessees have no intention of buying. In the trade, people call CORT's activity "rent-to-rent" to distinguish it from "lease-to-purchase" businesses that are, in essence, installment sellers of furniture.

However, just as Hertz, as a rent-to-rent auto lessor in short-term arrangements, must be skilled in selling used cars, CORT must be and is skilled in selling used furniture.

CORT's revenues totaled $389 million for calendar 2002, versus $395 million for calendar 2001. Of these amounts, furniture rental revenues were $316 million and $329 million, and furniture sales revenues were $73 million and $66 million. CORT contributed $2.4 million and $13.1 million to Wesco's consolidated operating income for 2002 and 2001, versus $29.0 million for the ten months that we owned it in 2000. These figures are before (1) goodwill amortization of zero for 2002 (see discussion above), $6.0 million for 2001 and $5.1 million for 2000, and (2) realized securities losses of $.7 million in 2000.

CORT's after-tax operating income (before goodwill amortization) for the entire calendar year 2000 was $33.4 million compared to only $2.4 million for 2002 and $13.1 million for 2001. 2002 was a terrible year in the ''rent-to-rent'' segment of the furniture rental business.

When we purchased CORT early in 2000, its furniture rental business was rapidly growing, reflecting the strong U.S. economy, phenomenal business expansion and explosive growth of IPOs and the high-tech sector. Beginning late in 2000, however, new business coming into CORT began to decline. With the burst of the dot-com bubble, the events of September 11, and continued weakness in the economy, CORT's operations have been hammered. Obviously, when we purchased CORT we were poor predictors of near-term industry-wide prospects of the ''rent-to-rent'' sector of the furniture business.

Moreover, CORT started up a new subsidiary during 2001, Relocation Central Corporation, whose operations should be considered as still in a ''start-up'' phase and, so far, have generated pre-tax losses amounting to $12.8 million in 2002 and $10.8 million in 2001. The results of its operations have been consolidated with those reported for CORT, shown above.

Relocation Central has developed a virtual call center which carries out an Internet-based furniture and apartment leads operation (www.relocationcentral.com), and it markets CORT's furniture rental services to real estate investment trusts, owners of many major apartment communities. As a result of the acquisition of its largest competitor in December 2002, Relocation Central operates in 20 metropolitan cities in sixteen states. CORT is hopeful that, through Relocation Central, it will ultimately become the principal source of rental furniture to the apartment industry, but this outcome is far from certain.

We expect to report in due course that all CORT operations have become more satisfactory, but prospects for 2003 do not seem good. However, there is good news along with bad. CORT has operated at a positive cash flow and the general distress in its field permitted various small expansions. During the past two years it invested $57 million in business expansion through acquisitions of several small businesses and reduced its line-of-credit debt by $30 million. CORT would not be making these acquisitions if we believed its furniture rental business prospects were permanently impaired.

When Wesco paid $386 million for CORT, about 60% of the purchase price was attributable to goodwill, an intangible balance sheet asset.

Wesco's consolidated balance sheet now contains about $266 million in goodwill (including $27 million from Wesco's 1996 purchase of KBS). The Financial Accounting Standards Board recently adopted a rule which became effective in 2002 that no longer requires automatic amortization of acquired goodwill. Thus, earnings we report more closely reflect microeconomic reality as we appraise it. As above shown in the first page of this letter, Wesco's reported earnings were reduced by about $7 million of mostly-non-tax-deductible amortization of goodwill for 2001, versus no such amortization for 2002.

More details with respect to CORT are contained throughout this annual report, to which your careful attention is directed.

CORT has long been headed by Paul Arnold, age 56, who is a star executive as is convincingly demonstrated by his long record as CEO of CORT. We are absolutely delighted to have Paul and CORT within Wesco, and are pleased with CORT's progress under his leadership, despite adverse developments in 2001 and 2002. We continue to expect a considerable expansion of CORT's business and earnings at some future time.

Precision Steel Warehouse, Inc. ("Precision Steel")

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, contributed $.3 million to Wesco's net operating earnings in 2002, down from $.4 million in 2001 and $1.3 million in 2000. Had it not been for LIFO inventory accounting adjustments, Precision Steel would have reported $.1 million for 2002 and no income at all for the year 2001, versus $1.7 million for 2000.

Last year we reported that the U.S. steel industry was generally a disaster in 2000, and that Precision Steel suffered worse effects than occurred for it in previous general declines in the U.S. steel business. The year 2001 was much worse. The absence of Precision Steel's operating earnings for 2001, before the effect of the LIFO adjustment, was due principally to a significant reduction in demand for steel, combined with intensified competition above the fierce level encountered in the prior year. This resulted in a 29.7% decrease in pounds of product sold. Sales revenues declined 25.6%.

We do not regard earnings changes from LIFO accounting adjustments, up or down, as material in predicting future earning power.

Terry Piper, who became Precision Steel's President and Chief Executive Officer late in 1999, has done an excellent job in leading Precision Steel through difficult years.

Tag Ends from Savings and Loan Days

All that now remains outside Wes-FIC but within Wesco as a consequence of Wesco's former involvement with Mutual Savings, Wesco's long-held savings and loan subsidiary, is a small real estate subsidiary, MS Property Company, that holds tag ends of real estate assets with a net book value of about $5.8 million, consisting mainly of the nine-story commercial office building in downtown Pasadena, where Wesco is headquartered. MS Property Company's results of operations, immaterial versus Wesco's present size, are included in the breakdown of earnings on page 1 within ''other operating earnings.''

Other Operating Earnings

Other operating earnings, net of interest paid and general corporate expenses, amounted to $.6 million in both 2002 and 2001. Sources were (1) rents ($3.3 million gross in 2002) from Wesco's Pasadena office property (leased almost entirely to outsiders, including Citibank as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiaries, less (3) general corporate expenses plus minor expenses involving tag-end real estate.

Corporate Governance

Two of our long-standing directors, Jim Gamble and Dave Robinson, are not standing for reelection. At practically no pay, they have been wise and honorable protectors of Wesco shareholders for many decades going back to a time before Berkshire Hathaway had any interest in Wesco. During their long tenure the value of Wesco stock appreciated about 5,000 percent. We will much miss their directorial service, but will not lose touch. They both retain offices in our building and will surely be in our offices from time to time.

Consolidated Balance Sheet and Related Discussion

Wesco carries its investments at market value, with unrealized appreciation, after income tax effect, included as a separate component of shareholders' equity, and related taxes included in income taxes payable, in its consolidated balance sheet. As indicated in the accompanying financial statements, Wesco's net worth, as accountants compute it under their conventions, increased to $1.96 billion ($275 per Wesco share) at yearend 2002 from $1.91 billion ($269 per Wesco share) at yearend 2001. The main cause of increase was net income after deduction of dividends paid to shareholders.

The foregoing $275-per-share book value approximates liquidation value assuming that all Wesco's non-security assets would liquidate, after taxes, at book value.

Of course, so long as Wesco does not liquidate, and does not sell any appreciated securities, it has, in effect, an interest-free ''loan'' from the government equal to its deferred income taxes on the unrealized gains, subtracted in determining its net worth. This interest-free ''loan'' from the government is at this moment

working for Wesco shareholders and amounted to about $28 per Wesco share at yearend 2002.

However, some day, parts of the interest-free ''loan'' may be removed as securities are sold. Therefore, Wesco's shareholders have no perpetual advantage creating value for them of $28 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than $28 per Wesco share.

Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway. Moreover, the quality disparity in book value's intrinsic merits has, in recent years, continued to widen in favor of Berkshire Hathaway.

All that said, we make no attempt to appraise relative attractiveness for investment of Wesco versus Berkshire Hathaway stock at present stock-market quotations.

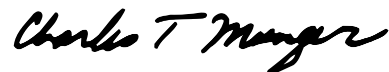
To progress from this point at a satisfactory rate, Wesco plainly needs more favorable investment opportunities, recognizable as such by its management, preferably in whole companies, but, alternatively, in marketable securities to be purchased by Wesco's insurance subsidiaries. Our views regarding the general prospects for investment in common stocks are contained in the following excerpt from Warren Buffett's recent letter to shareholders of our parent company:

> ''We continue to do little in equities. [We] are increasingly comfortable with our holdings in [our] major investees because most of them have increased their earnings while their valuations have decreased. But we are not inclined to add to them. Though these enterprises have good prospects, we don't yet believe their shares are undervalued.
>
> ''In our view, the same conclusion fits stocks generally. Despite three years of falling prices, which have significantly improved the attractiveness of common stocks, we still find *very* few that even mildly interest us. That dismal fact is testimony to the insanity of valuations reached during The Great Bubble. Unfortunately, the hangover may prove to be proportional to the binge.
>
> ''The aversion to equities that [we] exhibit today is far from congenital. We love owning common stocks — if they can be purchased at attractive prices. In [(Warren states:) my] 61 years of investing, 50 or so years have offered that kind of opportunity. There will be years like that again. Unless, however, we see a very high probability of at least 10% pre-tax returns (which translates to 6½-7% after corporate tax), we will sit on the sidelines. With short-term money returning less than 1% after-tax, sitting it out is no fun. But occasionally successful investing requires inactivity.''

In fact, the one thing that should interest Wesco shareholders most with respect to 2002 is that, as in 2001, Wesco found *no* new common stocks for our insurance companies to buy.

The Board of Directors recently increased Wesco's regular dividend from 32½ cents per share to 33½ cents per share, payable March 5, 2003, to shareholders of record as of the close of business on February 5, 2003.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.



Charles T. Munger
Chairman of the Board

March 6, 2003

Notes from the 2003 Wesco Annual Meeting, 5/7/03

By Whitney Tilson (WTilson@Tilsonfunds.com)

Note: This is not a transcript. No recording devices were allowed at the meeting, so this is based on 2 1/2 hours of rapid typing, combined with my memory (egads!). Other than the opening statement, I have reorganized the content of the meeting by subject area. Words in [brackets] are my comments or edits.

For more on this meeting, see my 5/9/03 column, Charlie Munger's Worldly Wisdom. For my columns and notes on previous Berkshire and Wesco meetings, click here.

To learn more about Munger, I recommend the book Damn Right: Behind the Scenes with Berkshire Hathaway Billionaire Charlie Munger. I also recommend reading my column and transcript of Munger's speech, "24 Standard Causes of Human Misjudgment," which has powerful implications for investors.

OPENING COMMENTS

This group is the hard core cultists. Most have actually been to the Berkshire meeting [last Saturday], sat through hours and hours of questions, and now here they are again. Some are doing it with other people's money, but many are doing it with their own money. If you've traveled this far, you're hard core.

Why do people come? Partly, I'm sure out of respect for the long-term record of compounding money at high rates. But also there's the cast of mind that helped create the record. I'm very sympathetic to people who share our twists of mind. If you're Warren Buffett and Charlie Munger, you're lonely. The whole of academia, business and economics believe a lot of things we don't believe at all, and conversely don't believe a lot of things we do believe.

Critique of the Efficient Market Theory and Institutional Money Managers

They used to criticize us bitterly, but stopped doing that when criticized by their heirs[?]. There's a world in academia where markets are perfectly efficient, where nobody knows if one company is better than another at any time, where value is dictated based on price. Then, it can never make any sense for a company to buy back its own stock. But if you say, "I can point to you many situations in which a stock was selling for 1/5th of its value, so why shouldn't a company buy it back?", some purists still won't change their minds. A corollary of this says that you can never find a price that is rational to buy a stock that you know a lot about.

It makes it hard for Warren and I to go on every year. We don't really care actually. [Laughter] In what other profession do the leading practitioners differ so much from the leading theorists? [Laughter] Hopefully this is not true in surgery, engineering and so forth.

Institutional money managers hire consultants who hire other consultants. They put money in venture capital, little companies, big ones, growth, value, etc. One thing that's sure is that at the end of the year, you've spent a lot on the consultants and frictional costs. Berkshire and Wesco never have and never will [behave this way].

20 Punches
Warren said at the Berkshire meeting (or maybe it was to the press afterward?), that he often tells business school students that if he gave them a card that only had 20 punches for a lifetime, and each time they made an investment they would use up one punch, and that after 20 punches there would be no more, then on average, with those rules, you'll die a lot richer. But people can't grasp this; they don't know what to make of it. But I believe it's true -- you'll do better over a lifetime [following the 20-punch way of thinking], assuming you're a smart, disciplined person. This room is filled with people who followed that advice. But that is absolute apostasy in academia.

How many different things has Wesco done since Blue Chip Stamps? [A major acquisition that Wesco made under Munger and Buffett's leadership in the 1970s.] We've only bought two or three companies and made a few big stock purchases. We've probably made a significant decision every two years. But nobody manages money this way. For one thing, clients won't want to pay you. [Laughter]

But our theory is that getting a real chance to invest at rates way better than average is not all that easy. I'm not saying it's not moderately easy to beat the indices by half a percentage point every year, but the moment you seek higher returns, is a very rarified achievement. The only way we know how to do this is to make relatively few investments of size.

What you can know if that if you spread your capital over a large number of securities, this will lead to average returns. Why anyone would pay a lot of money to learn what is so obvious is beyond me. [Laughter] I'm serious, people get paid to teach this! [Laughter]

It's not so bad to have one's money scattered over three wonderful investments. Suppose you were a real estate investor with a 1/3 interest in the best apartment complex in town, the best mall, and the best [I missed what he said -- another type of real estate investment]. Would you feel like a poor, undiversified investor? No! But as soon as you get into stocks, people feel this way. Partly, people need to justify their fees.

Envy is a Really Stupid Sin
Then there's the chasing of the investment return rabbit. What if you had an investment that you were confident would return 12% per annum. A lot of you wouldn't like that -- especially if you've done better -- but many would say, "I don't care if someone else makes money faster." The idea of caring that someone is making money faster [than you are] is one of the deadly sins. Envy is a really stupid sin because it's the only one you could never possibly have any fun at. [Laughter] There's a lot of pain and no fun. Why would you want to get on that trolley? [Laughter]

Options and Circle of Competency
We have a theory that you go through life in an orderly way. It gives us extra options. There's an obvious doctrine in life that all individuals and companies have to make decisions based on opportunity costs -- that's how all people make decisions. If you're married, you can keep [your spouse] but you always have the option to say, "I can do better elsewhere." Now you don't say this… [Laughter]

Most people have options: what job to take, school to go to, and so forth. One should measure investment opportunities this way. The more attractive things are, the higher the bar is. Berkshire has raised the opportunity bar by looking at stocks, bonds, private companies, public companies, etc. We have more opportunities by operating in a wider range.

The danger is that you have more risk of operating outside of your circle of competency. I don't think we're ever gone outside our circle of competency. We find things across a fairly wide range that we think is within our circle of competency. If you can widen your range and broaden your circle of competency, then you'll be a better investor.

Focus Investing
I remember when Warren was buying American Express when the company was suffering from a scandal [the 1963 Salad Oil Scandal]. Warren said to me, "I can't find anything else that's nearly as attractive." So, he asked his partners [this was before Berkshire, when he was managing the Buffett Partnership] to change the partnership agreement [which, I assume, prevented him from putting too much of the partnership into one position] and put 40% of his capital into American Express. When was the last time you saw a mutual fund do this [I'm not sure if he meant investing so heavily in one stock, or changing the contract with investors to take advantage of an opportunity]? It happens, but it's rare. To me, it's the most ordinary common sense, but it's not the most conventional wisdom of the time.

I know value investors who [I missed this]. There's a graduate of Stanford Business School who can compound money at 25% per annum so why does he need to invest other people's money, and he's now a very rich man. Warren operated out of a sun porch [in his house] for years.

Unattractive Investment Environment
At Wesco, we're in a state of arrest. We have way more capital than we're using. We have some investments in bonds that went up $20 or $30 million [over the past year], but this is not fun, watching and waiting, for people who have an action bias. Too much action bias is dangerous [however], especially if you're already rich.

In terms of the general climate, I think it's pretty miserable for anyone who likes easy, sure money. Common stocks may be reasonably fairly valued, but they are not overwhelming bargains. Interest rates are really low. When you get five-year rates under 3%, it starts getting really unpleasant for people who are used to better results. But I don't think this is a tragedy. If things get really bad, like Japan, then things will be very unpleasant. Think of how you'd like to run a big university under those circumstances. I don't think that will happen here -- I think we're a better place in terms of investing.

But the world can throw you a lot of surprises. Who would have predicted the World Trade Center, interest rates where they are, life insurers in Japan insolvent because they agreed to pay 3% interest per annum.

A New Way to Measure Returns
Think of professional money management. A typical fund might do well, the money comes in, and then there's a big collapse. If you took into account the negative results at the end, with the big money in the fund, the overall result would be negative. If I were running the world, I'd require all people running mutual funds and investment funds to report results in two ways: the

current way and per dollar year. The big funds would really look terrible because they took in really a lot of money and then collapsed. If you took venture capital, which did well with a small amount of capital, and then took in a huge amount of capital [and lost most of it], they'd have trouble shaving in the morning.

[To understand what Munger is talking about, consider a fund with $100 that has a spectacular year and doubles to $200, a 100% return. Money of course pours in (let's say $800), chasing this performance, such that the fund grows from $200 to $1,000. Then, the fund falls by 50% the next year to $500. The fund's IRR (internal rate of return) is 0% (a +100% year followed by a -50% year), yet investors have lost a massive amount of capital: a $100 gain in the first year, followed by a $500 loss in the second year.]

COMMENTS ON BERKSHIRE HATHAWAY

Berkshire Without Buffett

I said to my fellow directors of Berkshire quite recently, when we were discussing Berkshire in his [Buffett's] absence, "It's hard to believe that he's getting better with each passing year." It won't go on forever, but Warren is actually improving. It's remarkable: most almost-72-year-old men are not improving, but Warren is.

If he were gone, we couldn't invest the money as well as Warren, but the place is drowning in money -- we have great business pounding out money. If the stock went down, Berkshire could buy it back. There's no reason to think it will go to hell in a bucket, and I think there's reason to believe it could go on quite well. The people at MidAmerican Energy are quite formidable. I'd be horrified if it isn't bigger and better over time, even after Warren dies. And I can't imagine Ajit not being one of the jewels of the insurance business in the world as far as the eye can see.

If your problem is that eventually all things crest, then you're right. The loss of dominance rate is 100%. Every great civilization that was dominant eventually passed the baton. Similarly, the greatest companies of yore are not the great companies of hence. I like looking back and seeing who would have predicted what happened to [formerly great companies like] Kodak, Sears and General Motors.

Sure, vicissitudes come to all places, but I think Berkshire is structured so that it's unlikely to fall back the way GM has. GM basically transferred the enterprise value to the employees instead of the shareholders. That is not the Berkshire culture. We want employees to be esteemed, get rich and enjoy life, but we're not in business of deliberately transferring the company from shareholders to employees.

At GM, they tried to get by each year without a calamity [e.g., a strike] by giving [whichever union whose contract was due for renegotiation] a lot, which they then had to give to the other unions. Do this over 40 years and at the end there's nothing left for shareholders. That's not the culture at Berkshire.

Will it ever fail? I suppose it will. [I believe he was referring to Berkshire, not GM, in the context of his earlier comment, "Every great civilization that was dominant eventually passed the baton."]

Berkshire and Wesco's Stock Prices Relative to Intrinsic Value
We like the stocks of both Berkshire and Wesco to trade within hailing distance of what we think of as intrinsic value. When it runs up, we try to talk it down. That's not at all common in Corporate America, but that's the way we act.

At Berkshire, there's been a deafening silence [on what we think of the stock price]. Berkshire is trading in a reasonable way given our environment and opportunities, which is why we've been silent. We are in no distress at all about the current value of the stock, and we're the type who feel uncomfortable if the stock gets too high or too low.

I have yet to see a shareholder who needs to get out not be able to sell it. So far, we haven't had any crisis of liquidity. If there were a crisis of liquidity, there's someone around who has plenty of liquidity. [E.g., Buffett/Berkshire] [Laughter]

There have been two times that my Berkshire stock holdings have fallen by more than 50%. So what? Warren has always said that if you're not prepared to experience a 50% quotational loss, you shouldn't be in stocks.

Intrinsic Value of Berkshire vs. Wesco
[He gave two explanations -- I missed them -- and concluded:] Either way you calculate it, Berkshire has way more value per dollar of book value [than Wesco].

Berkshire's Advantages in Super Cat Insurance Underwriting
If it could easily be done, just by manipulating rules of statistics, like life insurance, then everyone would have done it and there wouldn't be much profit in it. But what you point out -- what everyone doesn't like about it -- is what we like about it. For example, there have been lots of earthquakes but the average actuary says that after 50 years without an earthquake, it means that one is now less likely. But we think that maybe pressure is building up, making it more likely not less. We try to take into account all of these factors.

There is a close collaboration between Warren and Ajit Jain. I've known both a long long time and if there are two better people on this earth to do this [super cat underwriting], I don't know who they are. We can't guarantee results, but they've done fine -- in fact, more than fine.

Sometimes they will do things where it's a straight Pascalian calculation -- the odds are x and we get paid at a rate that give us better odds than Las Vegas. The reason other people won't do it is because if they're wrong, it'll be a big money loss, but Berkshire can handle a big number loss. I'm quite comfortable watching those two people do it. I wish I could do it, but I can't. It's reasonable heuristics by two tough, sharp-minded men.

Event Arbitrage Investing and Berkshire's Junk Bond Investments in 2002
We haven't been doing much event arbitrage in recent years. In earlier years we did a fair amount, but now it's rare. The equivalent is we bought something around $10 billion of junk bonds last year, and $7 billion are left around. It's sort of similar to event arbitrage that Warren used to do in his earlier days. I don't think you'd find the recent records in event arbitrage are very good compared to the results we've had.

Warren calculated that over the past 60 years, if you combined Ben Graham's record and his, they generated returns of 20% per annum on event arbitrage. Ben Graham called them "Jewish Treasury Bills."

[Graham was Jewish. Here's the full story: When Buffett graduated from Columbia Business School, he offered to work for Graham at his investment firm, Graham-Newman, for free. Graham turned him down, even though Buffett was his only student to ever receive an A+ grade, because he only hired Jews. (This was not unusual at the time, as Wall Street had a number of all-Jewish firms to balance the many all-white, male, Christian firms.) Buffett returned to Omaha and worked as a stock broker (and occasionally wrote research reports on companies like GEICO) until Graham contacted him years later in 1954, after he had decided to open up the firm to non-Jews. Buffett took the job for two years, until Graham shuttered the firm in 1956, and then went back home to Omaha to open his own partnership. Incidentally, it was at Graham-Newman that Buffett met another legendary investor, Walter Schloss, who was also a junior analyst there.]

Now, that way of investing [event arbitrage] has gotten fashionable [today] because some money will be coming in even if world goes to hell in a hand basket. You can amuse yourself with that calculation as much as you want, but we tend not to do that. I suppose we could if the right opportunity came along. For one thing, its hard to do with a lot of capital.

The junk bonds are an interesting case. When we were buying [last year], the mutual [bond] funds were getting net redemptions and had to sell. Even under those conditions, we only got $8 or $10 billion invested. Now, the mutual funds have net inflows and you can't buy anything.

[I share Munger's bearish on bonds, as I argued in Don't Chase Performance.]

More on Bonds
Warren's doing most of the work on Berkshire's bond portfolio. I scarcely look at them.

We normally don't talk about what we are or aren't investing in, but I can't help saying that we don't own tobacco bonds. As for the WPPSS bonds, we bought every bond that traded, but we could only buy $300 million. It's hard to invest large sums of money.

[According to Of Permanent Value: The Story of Warren Buffett (a wonderful 1,490 page tome for true Berkshire junkies), "Buffett quietly bought $139 million worth of Projects 1, 2, and 3 of Washington Public Power Supply System bonds in 1983 and 1984…Buffett explained how WPPSS had defaulted on $2.2 billion worth of bonds issued to help finance Projects 4 and 5. That stigma stained other projects and Buffett was able to buy the bonds at a steep discount."]

Berkshire's SQUARZ deal in 2002
Warren has a big motor and there isn't enough going on at Berkshire with a tiny pile of assets and an insufficient number of large businesses [laughter] so when he sees a mispriced security, so he's willing to issue it. Personally, I wouldn't issue it. But it's one of Warren quirks. Remember the LIONS [a security Berkshire issued long ago]? We only have to put up with this every 20 years. To Warren, the appeal is that it could be done. I think the mere fact of borrowing money at a negative interest rate turned him on [because] not many people are able to do that. Just call it an intellectual quirk.

[For more on the SQAURZ deal, see my column, Berkshire's Unusual Security.]

Berkshire's Acquisition Strategy
We've bought business after business because we admire the founders and what they've done with their lives. In almost all cases, they've stayed on and our expectations have not been disappointed.

Buying Stock vs. Entire Companies
We do both, but we get tax advantages by buying whole companies rather than stocks -- very significant ones. Also, if we buy a company, we can change management, dividend policy, etc. if we need to.

We'll pay more per share for 100% of a company than 3%, but practically everyone else will too.

Why Did Berkshire Bid for Burlington Industries?
That's very easy: Burlington has a segment that relates to Shaw. Shaw does flooring and carpets [so there's a part of Burlington that] would fit in nicely with Shaw. What wouldn't fit in, we were will to buy for the price we offered. It was a peculiar add-on thing. We haven't suddenly decided that textiles are the thing.

The judge was willing to have us give the company a put [for an inadequate fee]. In our world, puts are worth a lot of money. There was a perfectly reasonable judge, but we're perfectly reasonable too, so we walked.

A Change in Dividend Tax Policy Wouldn't Change Us
[At the Berkshire meeting, Warren did talk about dividends. It [making dividends tax-free] wouldn't change us. Our long-stated policy is that as long as we think that, over an extended period of time, we think we can create more than $1 of value for every $1 retained, then we'll retain it. If that changes, we'll shell it out.

Would Corporate America change if dividends could be distributed tax free? Sure. For one thing, people would think the law might change [and therefore rush to pay out dividends before they became taxable again].

Failing to Buy Wal-Mart Stock
Wal-Mart was an $8 billion sin. What happened is that we started to buy it and the price started to go up and we're naturally so cheap that we stopped buying. It's not $8 billion we lost, but $8 billion we didn't gain. We keep doing this. We haven't done this hundreds of times, but our sins of omission have cost us a lot in terms of opportunity. I wish I could tell you we won't do this again. We do find things to actually do and they tend to work out well. If we only could have been 5% smarter, our shareholders would be a lot better off.

Costco and Wal-Mart
Costco [Munger is on the Board] and Wal-Mart are two of the most admirable retailing operations in the history of the world. In fact, Wal-Mart has the best retailing record in the history of the world. It was started by a guy in his 40s and he hasn't been dead that long. There's a similar story at Costco. Costco would be worth a lot more money if there weren't any

Wal-Mart [Laughter]. Sam Walton talked to Sol Price about buying what is now Costco, but those two titans never got together. We screwed up by not buying Wal-Mart stock, and Wal-Mart screwed up by not paying whatever price Sol Price wanted.

Future Relationship With Wal-Mart
Obviously based on past history, with Garan and McLane, we trust Wal-Mart. [Wal-Mart accounts for more than 85% of Garan's sales.] We admire Wal-Mart. How could you have a good value system and not admire Wal-Mart?

[When asked about Berkshire expanding its relationship with Wal-Mart to put Dairy Queens in Wal-Mart, sell GEICO insurance, knives, etc. through Wal-Mart, Munger replied:] I wouldn't get carried away with two transactions. Wal-Mart has perhaps the best buying systems on earth. They won't be buying from us because they like us. We wouldn't want it any other way. I wouldn't expect any fast flood of products into Wal-Mart.

COMMENTS ON BERKSHIRE HATHAWAY AND WESCO HOLDINGS

McLane
Obviously we like the manager [of McLane, Grady Rosier] a great deal, and obviously we trust Wal-Mart to stay with us as a major customer. Obviously we think it's a good buy at the price we paid. What more can I say? It's not some business that's going to grow at fantastic rates forever and ever, partly because one of its main products is tobacco. But we didn't pay for a business that's going to grow forever and ever. We like buying decent businesses at fair prices.

You should think of a business like McLane not as a normal merchandising business -- it's a logistics business like FedEx or UPS. It's a super-slick, super-efficient system for carrying out a logistics function. I think Wal-Mart sold it because they're the best in the world at retailing and they want to concentrate at what they're best at. I would too.

Clayton Homes
We wouldn't have bought Clayton Homes if the family members weren't there and weren't planning to remain. With reference to the price, the entire industry worked itself into a disastrous collapse with vast oversupply of used units, big financial losses, etc. Even Clayton has felt the effects of this calamity. We think Berkshire will help make Clayton stronger. We agree that Clayton is the jewel of the industry. We're buying at period of maximum distress. We think it's okay for Berkshire and okay for Clayton shareholders.

A lot of people wouldn't be interested because they can't stand taint. There's nothing wrong with Clayton, but the whole industry is tainted. We're willing to do things like that all of the time. Our triple A credit rating won't hurt Clayton [Laughter]. Everything you like about Clayton's culture -- does it seem that inconsistent with Berkshire's culture?

I've always felt that manufactured housing should have a bigger place in our society. It might morph into something different. Houses are built in many places in a very inefficient way.

CORT Business Services
CORT [which Wesco acquired in January 2000] has been clobbered by the big dot-com decline. The whole temporary office business in the country had a huge boom. Law firms, accounting

firms, venture capital firms, etc. all expanded. When they went bust, rental firms went bust. In that business, we caught a big recession.

We're having a similar recession in NetJets in that used jets have gone down in price. CORT and NetJets are losing a lot of money. Do I think CORT is going to fail? No. Net Jets? No. There are vicissitudes in life. In fact, we're buying other furniture rental companies. Some people vote with their feet; we vote with our wallets. Was our timing great in buying CORT? No, it was terrible.

Asbestos and Berkshire's Investment in USG
Obviously, so far at least, USG has not been one of our happiest moments. Everyone in American has underestimated how much asbestos could cost. One reason is that an awful lot of money goes to people who haven't been hurt -- way more than half goes to lawyers and experts and those who haven't been hurt. They [the country] did it a lot better when they had [a settlement] for black lung [disease] for coal miners. They simply put a tax on coal and all the money didn't go to lawyers and people who weren't sick.

In my judgment, the common stock of USG won't go to zero, but how well it will work out on the plus side, from zero to infinity, I'll leave you to figure out.

Won't Talk About Investments
[When asked to comment on Berkshire's investment in Mueller Industries (NYSE: MLI; a manufacturer of brass, copper, plastic and aluminum products; Mueller also owns a short-line railroad and various natural resource properties in the western United States), Munger replied:] We ordinarily don't talk about the reasons for making particular investments. We don't want people following us into particular stocks. It's sort of like asking, "What are you buying tomorrow?" We tend not to answer those questions.

INVESTMENT ADVICE

Attractive Investment Opportunities Tend to Be Ephemeral
A lot of opportunities in life tend to last a short while, due to some temporary inefficiency. If you're Berkshire, you can get a few billion dollars out, but most institutions would miss it -- they would have to meet with trustees, lawyers, etc. By the time they were done, they'd have missed it. In this environment, you have to be present and ready to act. Look at some of our recent acquisitions. They faced default and needed money by Monday, and it was Friday afternoon. It was an ephemeral opportunity. For each of us, really good investment opportunities aren't going to come along too often and won't last too long, so you've got to be ready to act and have a prepared mind.

Cigar-Butt Investing and the Value of Meeting With Management
I don't think Warren would think it [cigar-butt investing] was useless -- he just doesn't want to do it. [Laughter] And he trained under Ben Graham, who said, "Just look at the facts. You might lose an occasional valuable insight, but you won't get misled." If you sit down and talk to the key manager for an hour and you're a smart person, I think that could be a significant plus. But a smart person might be right 60% of the time and, for the balance, be misled. If you have some specific questions that the management is going to answer, obviously that would be helpful.

Warren reads a lot of what people have written. He just doesn't want to do it [spend a lot of time talking to managements]. There's a good argument that at a certain level of skill, you're better off without it, especially if you're Warren Buffett. But even he finds it helpful.

I remember a few years ago, Warren met with a CEO and afterward said he thought the CEO wasn't very shareholder friendly and was the biggest horse's ass. So we didn't invest and the stock compounded at 15% per annum for 20 years.

Views on Ben Graham's Ideas

The idea of a margin of safety, a Graham precept, will never be obsolete. The idea of making the market your servant will never be obsolete. The idea of being objective and dispassionate will never be obsolete. So Graham had a lot of wonderful ideas. Warren worshipped Graham. He got rich, starting essentially from zero, following in the footsteps of Graham.

I liked Graham, and he always interested and amused me. But I never had the worship for buying the stocks he did. So I don't have the worship for that Warren does. I picked up the ideas, but discarded the practices that didn't suit me. I don't want to own bad businesses run by people I don't like and say, "no matter how horrible this is to watch, it [the stock] will bounce by 25%." I'm not temperamentally attracted to it.

[For more on Graham, read his classics: The Intelligent Investor [the single greatest book on investing, in my opinion] and Security Analysis. Another book I recommend on Graham is The Rediscovered Benjamin Graham. Finally, my friend Rich Rockwood wrote a nice piece on Graham's thinking recently, Invest the Buffett Way.]

Diversification and Circle of Competence

95% of American managements, the minute they get out of their chosen activities, why shouldn't they just slaughter themselves? I think most managements are nice people, but their general powers of capital allocation are inadequate. And the people advising them, the investment bankers, etc., they will mislead you 95% of the time. The consequences for the utilities that tried to diversity were lethal.

Why are we different? We're working harder at trying to be rational. If you don't work hard at it, and just float along, you will fall victim to the folly of the crowd -- and there will always be folly of the crowd. I wish people would learn more from this than I think they will.

A Shareholder Case Study

[A shareholder stood up and said he first discovered Buffett and Munger and bought Wesco stock in 1984, and kept buying more -- and also added Berkshire stock -- despite Munger talking down Wesco all the time. Munger replied:] If I was steering you toward Berkshire rather than Wesco, then I hope I didn't hurt you. [Laughter]

The man who just spoke is teaching by providing an example of what I was talking about earlier. Here's a guy who is acting like he has 20 punches in life. He likes these guys [Buffett and Munger], gets to know them better, doesn't ask a consultant if he should buy a burlap bag manufacturer in India -- he just kept buying what he knows and has confidence in.

[Munger then asked the shareholder:] How many investments have you made in which you had as much confidence as you had in us?

Shareholder: "Maybe 10."

Munger: "A typical rich shareholder, which means he probably doesn't have a chauffer."

Shareholder: "I drive a '94 Buick."

Munger: "They won't teach this in all of the finance departments. Maybe you should give all of the money back." [Laughter]

Investing Taught at Business Schools
There are a handful of business school professors who teach investing properly. Jack McDonald of Stanford Business School, for one. He comes to the Berkshire meetings. I've taught in his class and Warren has come to his class. There are others.

Reforming academia, except accidentally by having a view that catches on, isn't something I try. It's amazing how difficult it is to change ideas, no matter how wrong they are.

Neither Warren nor I has ever thought for two seconds about beta. But every business school teaches this [concept]. Maybe if we had a few more hundreds of billions of dollars, people would pay attention to us. [Laughter]

Competitive Threat from China
If you're in any business of a manufacturing nature that China can do well, after you consider transport, then you're in the crosshairs of a very formidable opponent.

Why didn't we recognize this with the shoe business? Well, as a German philosopher once said, "Too soon old and too late smart."

Comments on Philip Fisher
Phil Fisher believed in concentrated investing and knowing a lot about your companies -- it's in our playbook, which is partly because we learned from him.

[For more on Fisher, I recommend his books: Common Stocks and Uncommon Profits [one of the all-time great books on investing, in my opinion], Conservative Investors Sleep Well, and Developing an Investment Philosophy.]

Recommended Reading for Investors
I think the business publications, because they digest so much so well, are a good resource. There's a lot of brainpower on the staffs of Fortune, Forbes and The Wall Street Journal.

RISKS IN THE FINANCIAL SYSTEM

Derivatives
It's easy to see [the dangers] when you talk about [what happened with] the energy derivatives -- they were kerflooey. When they [the companies] reached for the assets that were on their books,

the money wasn't there. When it comes to financial assets, we haven't had any such denouement and the accounting hasn't changed, so the denouement is ahead of us.

We tried to sell Gen Re's derivatives operation and couldn't, so we started liquidating it. We had to take big markdowns. I would confidently predict that most of the derivative books of [this country's] major banks cannot be liquidated for anything like what they're carried on the books at. When the denouement will happen and how severe it will be, I don't know. But I fear the consequences could be fearsome. I think there are *major* problems, worse than in the energy field, and look at the destruction there.

Consumer Credit
Consumer credit has been a gold mine -- it's like selling heroin to addicts. There are a lot of fiscalaholics [a new Mungerism] who will probably find some way to pay their bills. Some banks understood this and made a great deal of money.

What I said last year was that it made me nervous, that constant pushing of consumer credit. I didn't say when [a blow-up might occur], but it still makes me nervous.

COMMENTS ON OTHER ECONOMIC MATTERS

The Banking Industry, Past and Future
The banking industry has been a gold mine. I think Warren and I blew it -- we should have invested a lot of money in banks. While we did well in it, we should have been heavier in it. The amount of money made in banking has been awesome. And [this despite the fact that] the people who made the money -- how shall I say it -- have been moderately skillful. [Laughter] [I think he said something here about one being able to make a lot of money in banking even if one is "a perfect ass."] [Bankers have been like] a duck sitting on a pond and they raised the pond. By borrowing short and lending long, one can make a lot of money. It's so easy that people are tempted to do more and more.

Can it go on forever? A wise economist once said, "If a thing can't go on forever, it will eventually stop." My guess is that the extremes are over. Banking has been a marvelous business, but I wouldn't think it would continue to get better and better and it might even get a lot worse.

Pension Fund Consultants
I'm glad you asked, as it gives me a chance to talk about a deeper reality. [Laughter] Let's compare pension fund consulting with bass fishing. You can go on the bass fish tour and catch bass and get prizes. Or you can go into the business of selling tackle and giving advice to bass fisherman. They are two different businesses. The people who choose the latter wouldn't be very good at catching bass. That's how Warren and I view things. We want to win the bass fishing tour, whereas pension fund consultants sell tackle. We're not interested in selling tackle, we're interested in catching bass.

Housing Boom
We've had a boom in housing that has been almost unprecedented in the country, and it keeps going on despite setbacks in certain places. It's partly due to interest rates being so low, and partly because everyone who previously bought [houses] did so well. But in some places, like

Silicon Valley, prices got so high that they've come down. I don't know a lot about the housing price market. I wouldn't have predicted that a little house in Palo Alto would be worth $3.5 million. It took a good educational system and being amidst the Silicon Valley boom.

Having failed to predict accurately [what would happen in the housing industry] in the past, I don't know why, based on a clear lack of competency, why I should predict anything now. Ordinarily, [my advice is to] buy housing when you need it, and don't try to time the market.

ADVICE ON LIFE AND OTHER (MUNGER'S WORLDLY WISDOM)

Approach to Life

We've tried to do that [convey our philosophy] in everything we've ever done and said. But you can't say: "Please dispense all wisdom in one sentence." We're just not up to it. Other people have tried. If you want it short, try Buddha, who said: "I only teach one thing: I teach the cause of human sorrow and how to avoid some of it." (This isn't word for word, but some of it.)

That's my approach: Go around figuring out what doesn't work and then avoid it -- and when you get the sorrow, how to handle it. I think this is a very rational approach to the human condition. If you want to avoid sorrow, you gotta know the cause of sorrow. There are certain ways of improving life that have a certain outcome.

If it's trite, it's right. That's not totally true, but mostly true.

How to Get Rich

We get these questions a lot from the enterprising young. It's a very intelligent question: you look at some old guy who's rich and you ask, "how can I become like you, except faster?" [Laugher] My answer is that I did it slowly, inch by inch, taking losses mentally when they occurred. If you want to do it with fast rapidity, then you're talking to the wrong man, but I know my way works.

If you don't just want to play tiddlywinks, I say welcome to the pool. Spend each day trying to be a little wiser than you were when you woke up. Discharge your duties faithfully and well. Step by step you get ahead, but not necessarily in fast spurts. But you build discipline by preparing for fast spurts. You may not need Zsa Zsa Gabor or a Lamborghini or a lot of other things you think you need now. Slug it out one inch at a time, day by day, at the end of the day -- if you live long enough -- most people get what they deserve.

It's so simple. What's the best way to get a good spouse? The best single way is to *deserve* a good spouse because a good spouse is by definition not nuts. [Laughter] It's the same with the responsibilities in life.

Iraq and Afghanistan

As for Iraq and Afghanistan, your guess is as good as mine. But I will say that it's very easy to shrink from something unpleasant and conclude we don't really need it. At least I admire the ability to suffer now in the hopes of making something better. I'm skeptical of the approach that never finds it necessary to suffer now to make it better. There's a lot to be said to seeking ways to suffer now to make things better. That's the way it is in investing -- sacrifice now in the hopes

of something better. Now whether it will actually turn out better [in the Middle East], your guess is as good as mine, but I kind of like the fact that we tried.

[For more on this, see my two columns, Iraq and Investing and Weathering Iraq's Storm.]

Don't Change the Dividend Tax Policy
I think in a democracy, you have to kind of work to keep appearances not too unfair. The way to do this is to keep the reality not too unfair. I think that to some cab driver working seven days a week and paying taxes at a 40% rate, that someone at the country club paying zero tax would be unacceptable. Look what happened when American Airlines executives took part of their compensation and made it secure. The resentment among the workers, who were being asked to sacrifice, was overwhelming -- and I think rightly so.

I think if you make it [e.g., become wealthy], then you have a duty not to mess up the system. I think Corporate American has been terrible at setting an example. If you rise in life, you have to behave in certain way. You can go to a strip club if you're a beer-swilling sand shoveler, but if you're the Bishop of Boston, you shouldn't go. [Laughter]

Opinion on a Temporary Wealth Tax
The wealth tax has existed in the past. For example, immediately after WW II, to recover from the war, Germany instituted a temporary wealth tax and people cheerfully paid it. In this country, I think that once people got accustomed to it, it would stay [e.g., politicians would make it permanent].

Estate Taxes
I like the idea of retaining gift and death taxes, but as for the guy who builds up a good business worth $5 million and wants to pass it to his children, I think the death tax should be zero. But for people who really strike it big, I think there should be an intergenerational tax.

Intergenerational Tensions
If the growth rate of the country goes to zero, then of course we'll have intergenerational tensions. If it continues to grow at 2% -- per capita real growth of 2% per annum -- then we won't, and Social Security will be okay.

Don't Invest Part of Social Security in Stocks
People grew accustomed to stocks doing well. A lot of people behind these schemes thought stocks would yield very high returns over a long period of time. I don't have any gospel from god that stocks will yield 8-10% real returns over a long period. But I do have faith that if government gets involved, it will gum it up. I don't want trustees appointed by the government voting shares of the common stocks in America. Leave it well enough alone.

Common stocks are valued in 2 ways: 1) rational estimates based on future use value [e.g., as Buffett has said in the past: future cash flows that the underlying businesses will generate from now until kingdom come, discounted back to the present at an appropriate rate]; 2) in the hopes that they will go up because people want to buy them. Like bonds and Rembrandts. Once you have government buying stocks every year like [they are] Rembrandts, God knows what would happen. This doesn't appeal to me at all. I'm afraid of it, afraid of the politics, and I don't believe the numbers of those projecting them. By the way, the numbers of those proposing this

idea three years ago now look silly. What would happen to the morale of this country if [we invested Social Security into stocks and then what's happened over the past 20+ years in Japan happened here? Imagine that the] government of Japan had put [their] Social Security into common stocks. For a while, stock prices went up and everyone felt good, consumers and politicians spent more, etc., and then stocks declined by 80%. I think they'd be in even worse shape. The more anything sounds like easy free money, the less I tend to believe it.

Giving Money Away
I don't like to think of bequests, not because it reminds me that I'm going to die, but because I find it very hard to figure out what to do with money. Some people like to have people come up to them asking for money, but I don't.

I know a lot of people who like to remain anonymous when they give away money, and you may think that this is a becoming modestly, but mostly it's because they're afraid someone else will ask them for more money.

Charities Cooperating More
In terms of getting all charities in the world to act together, I can't get all of my children to act together, and they've been in my house and under my control.

View of Liberal Art Faculties
[Every year, Munger takes a shot at what he believes are clueless, disconnected-from-reality liberal art faculties at major universities. This year was no exception:]
I think liberal art faculties at major universities have views that are not very sound, at least on public policy issues -- they may know a lot of French [however]. [Laughter]

The Importance of Reading
In my whole life, I have known no wise people (over a broad subject matter area) who didn't read all the time -- none, zero. Now I know all kinds of shrewd people who have done well by staying in a narrow area. But investing requires broad knowledge.

You'd be amazed at how much Warren reads -- at how much I read. My children laugh at me. They think I'm a book with a couple of legs sticking out. [Laughter]

Recommended Reading
A Matter of Degrees, by physicist named Segre, is a perfectly marvelous book. Not a book you can go through at 90 mph, but if you parse through it slowly, you'll get a lot out of it. You'll get a lot of hours per dollar if you use it right.

How much GNP per capita there is really matters. It multiplied by seven times in a single century [in the U.S.] -- a lot by previous history of man. I certainly recommend the Carnegie biography by the Grinnell guy -- I forget his name [he was referring to Andrew Carnegie by Joseph Frazier Wall], but it's the definitive biography. It's a very interesting story. Carnegie started in absolute poverty and had only 4 1/2 years of grade school in a one-room schoolhouse with only one teacher for 170 or 180 students. From this beginning came Carnegie Steel and all of his eccentricities. He was married at 51 and was a virgin -- it was a different world. [Laughter]

It's very interesting -- the past is strange. People behave differently there. [Laughter] The way labor was treated was really something. People did dangerous work, had no Workman's Comp, insurance or pensions, companies could arbitrarily slash their pay by 40%, etc. And that was only 100 years ago. It makes you think how different the world will be 100 years from now.

Johnson, Adams and Franklin Biographies

Yes, I've read the whole Johnson biographies [Robert Caro's trilogy: The Path to Power, Means of Ascent, and Master of the Senate] and I've read the Adams biography [John Adams by David McCullough] and the various Franklin biographies.

Sure, Franklin was quite old when he was ambassador to France. This was after he was world famous and rich, and he was more self-indulgent than when he was young and making his way in the world. But he was a very good ambassador and whatever was wrong with him from John Adams's point of view [I'm sure] helped him with the French. [Laughter] I think Franklin was a marvelous steward. I'm willing to take the fellow as he averaged out. And certainly I'm in favor of old people having a little enjoyment. [Laughter]

WESCO FINANCIAL CORPORATION

Annual Report 2003

Form 10-K Annual Report 2003

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated net ''operating'' income (i.e., before realized securities gains shown in the table below) for the calendar year 2003 decreased to $39,958,000 ($5.61 per share) from $52,718,000 ($7.40 per share) in the previous year.

Consolidated net income increased to $74,711,000 ($10.49 per share) from $52,718,000 ($7.40 per share) in the previous year.

Wesco has four major subsidiaries: (1) Wesco-Financial Insurance Company (''Wes-FIC''), headquartered in Omaha and engaged principally in the reinsurance business, (2) The Kansas Bankers Surety Company (''Kansas Bankers''), owned by Wes-FIC and specializing in insurance products tailored to midwestern banks, (3) CORT Business Services Corporation (''CORT''), headquartered in Fairfax, Virginia and engaged principally in the furniture rental business, and (4) Precision Steel Warehouse, Inc. (''Precision Steel''), headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended			
	December 31, 2003		December 31, 2002	
	Amount	Per Wesco Share[2]	Amount	Per Wesco Share[2]
Operating earnings:				
Wesco-Financial and Kansas Bankers insurance businesses —				
Underwriting	$15,711	$ 2.21	$ 3,829	$ .54
Investment income	30,925	4.34	45,642	6.41
CORT furniture rental business	(6,257)	(.88)	2,442	.34
Precision Steel businesses	(860)	(.12)	250	.03
All other ''normal'' net operating earnings[3]	439	.06	555	.08
	39,958	5.61	52,718	7.40
Realized investment gains	34,753	4.88	—	—
Wesco consolidated net income	$74,711	$10.49	$52,718	$7.40

(1) All figures are net of income taxes.

(2) Per-share data are based on 7,119,807 shares outstanding. Wesco has had no dilutive capital stock equivalents.

(3) Represents income from ownership of the Wesco headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the insurance subsidiaries, less interest and other corporate expenses.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The foregoing supplementary breakdown is furnished because it is considered useful to shareholders. The total consolidated net income shown above is, of course, identical to the total in our audited financial statements.

Insurance Businesses

Consolidated operating earnings from insurance businesses represent the combination of the results of their insurance underwriting with their investment income. Following is a summary of these figures as they pertain to all insurance operations (in 000s):

	Year Ended December 31, 2003	2002
Premiums written	$ 86,962	$ 88,411
Premiums earned	$106,651	$ 64,627
Underwriting gain	$ 24,171	$ 5,891
Dividend and interest income	44,118	70,007
Income before income taxes	68,289	75,898
Income tax provision	(21,653)	(26,427)
Total operating income — insurance businesses	$ 46,636	$ 49,471

Following is a breakdown of premiums written (in 000s):

	2003	2002
Wes-FIC —		
Aviation pools	$36,652	$40,052
Property-casualty pool	30,390	27,691
Other	70	12
Kansas Bankers	19,850	20,656
Premiums written	$86,962	$88,411

Following is a breakdown of premiums earned (in 000s):

	2003	2002
Wes-FIC —		
Aviation pools	$ 44,316	$24,393
Property-casualty pool	42,021	20,913
Other	119	77
Kansas Bankers	20,195	19,244
Premiums earned	$106,651	$64,627

Following is a breakdown by company of after-tax results (in 000s):

	2003	2002
Underwriting gain —		
Wes-FIC	$11,158	$ 62
Kansas Bankers	4,553	3,767
	15,711	3,829
Net investment income —		
Wes-FIC	28,998	42,042
Kansas Bankers	1,927	3,600
	30,925	45,642
Total operating income — insurance businesses	$46,636	$49,471

As shown above, operating income includes significant net investment income, representing dividends and interest earned from marketable securities. However, operating income excludes investment gains of $34.8 million, net of income taxes, realized in 2003. No investment gains were realized in 2002. The discussion below will concentrate on insurance underwriting, not on the results from investments.

Wes-FIC engages in the reinsurance business, occasionally insuring against loss from rare but horrendous ''super-catastrophes.'' In much reinsurance sold by us, other Berkshire subsidiaries sold several times as much reinsurance to the same customers on the same terms. In certain instances but not always, such subsidiaries have taken from us a 3%-of-premiums ceding commission on premium volume passed through them to Wes-FIC. Excepting this ceding commission, Wes-FIC has had virtually no insurance-acquisition or insurance administration costs. In some cases, other Berkshire subsidiaries act as reinsurers at higher levels than the level at which Wes-FIC is reinsuring; terms of the reinsurance are considered by Wes-FIC to be fair or advantageous to Wes-FIC.

Underwriting results of Wes-FIC in 2003 were weirdly favorable, causing the underwriting gain of $15.7 million. Such weirdly favorable results are not to be expected over the long term. It should be recalled that Wes-FIC reported an underwriting loss of $8.1 million as recently as 2001. However, we do try to create some underwriting gain as results are averaged out over many years.

Kansas Bankers was purchased by Wes-FIC in 1996 for approximately $80 million in cash. Its tangible net worth now exceeds its acquisition price, and it has been a very satisfactory acquisition, reflecting the sound management of President Don Towle and his team.

Kansas Bankers was chartered in 1909 to underwrite deposit insurance for Kansas banks. Its offices are in Topeka, Kansas. Over the years its service has continued to adapt to the changing needs of the banking industry. Today its customer base, consisting mostly of small and medium-sized community banks, is spread throughout 28 mainly midwestern states. In addition to bank deposit guaranty bonds which insure deposits in excess of FDIC coverage, KBS offers directors and officers indemnity policies, bank employment practices policies, bank insurance agents professional errors and omissions indemnity policies and Internet banking catastrophe theft insurance.

KBS increased the volume of business retained effective in 1998. It had previously ceded almost half of its premium volume to reinsurers. Now it reinsures only about 11%. The increased volume of business retained comes, of course, with increased irregularity in the income stream.

The combined ratio of an insurance company represents the percentage that its underwriting losses and expenses bear to its premium revenues. KBS's combined ratio has been much better than average for insurers, at 65.0% for 2003 and 71.3% for 2002. We continue to expect volatile but favorable long-term effects from increased insurance retained.

CORT Business Services Corporation (''CORT'')

In February 2000, Wesco purchased CORT Business Services Corporation (''CORT'') for $386 million in cash.

CORT is a very long established company that is the country's leader in rentals of furniture that lessees have no intention of buying. In the trade, people call CORT's activity ''rent-to-rent'' to distinguish it from ''lease-to-purchase'' businesses that are, in essence, installment sellers of furniture.

However, just as Hertz, as a rent-to-rent auto lessor in short-term arrangements, must be skilled in selling used cars, CORT must be and is skilled in selling used furniture.

CORT's revenues totaled $360 million for calendar 2003, versus $389 million for calendar 2002. Of these amounts, furniture rental revenues were $276 million and $309 million, furniture sales revenues were $68 million and $73 million, and apartment locator fees of Relocation Central Corporation, a subsidiary CORT started up in 2001, were $16 million and $7 million. CORT operated at an after-tax loss of $6.3 million for 2003; it contributed $2.4 million and $13.1 million to Wesco's consolidated operating income for 2002 and 2001. These figures are significantly worse than CORT's $29 million of after-tax operating profits for the ten months that we owned it in 2000. Recent years were terrible in the ''rent-to-rent'' segment of the furniture rental business. The figures are before (1) goodwill amortization of zero for 2003 and 2002 (see discussion below), $6.0 million for 2001 and $5.1 million for 2000, and (2) realized securities losses of $.7 million in 2000, but include Relocation Central's after-tax losses, less minority interest, of $9.0 million for 2003, $8.3 million for 2002 and $7.0 million for 2001. Excluding the operating losses of Relocation Central, CORT, at the parent company level, contributed $2.7 million to Wesco's consolidated after-tax operating earnings for 2003, versus $10.7 million for 2002 and $20.1 million for 2001.

When we purchased CORT early in 2000, its furniture rental business was rapidly growing, reflecting the strong U.S. economy, phenomenal business expansion and explosive growth of IPOs and the high-tech sector. Beginning late in 2000, however, new business coming into CORT began to decline. With the burst of the dot-com bubble, the events of September 11, and continued weakness of job growth in the economy, CORT's operations have been hammered. Obviously, when we purchased CORT we were poor predictors of near-term industry-wide prospects of the ''rent-to- rent'' sector of the furniture business.

Moreover, CORT started up a new subsidiary during 2001, Relocation Central Corporation, which has developed a virtual call center and carries out an Internet-based furniture and apartment-leads operation (www.relocationcentral.com), and it markets CORT's furniture rental services to real estate investment trusts, owners of many major apartment communities. As a result of the acquisition of its largest competitor in December 2002, followed by some office closures, Relocation Central operates in 15 metropolitan cities in fourteen states. CORT is hopeful that, through Relocation Central, it will ultimately become the principal source of rental furniture to the apartment industry, but this outcome is far from certain. Its operations should be considered as still in a ''start-up'' phase. CORT has recently begun the process of reorganizing Relocation Central's operations, including relocating various of its

facilities into CORT's, withdrawing from markets having unsatisfactory potential, and aggressively trimming its expenses, in an attempt to improve its operations, which so far have not been satisfactory. The results of its operations have been consolidated with those reported for CORT, shown above.

We expect to report in due course that all CORT operations have become more satisfactory. CORT has operated at a positive cash flow and the general distress in its field has permitted various small expansions. During the past three years it invested $61 million in business expansion through acquisitions of several small businesses and reduced its line-of-credit and other debt by $50 million. CORT remains the national leader in its market segment and would not be making these acquisitions if we believed its furniture rental business prospects were permanently impaired.

When Wesco paid $386 million for CORT, about 60% of the purchase price was attributable to goodwill, an intangible balance sheet asset.

Wesco's consolidated balance sheet now contains about $267 million in goodwill (including $27 million from Wesco's 1996 purchase of KBS). The Financial Accounting Standards Board adopted a rule which became effective in 2002 that no longer requires automatic amortization of acquired goodwill. (The requirement for such amortization has been replaced by a standard that requires an annual assessment to determine whether the value of goodwill has been impaired, in which event the intangible would be written down or written off, as appropriate.) The earnings we have reported for 2002 and 2003, without deduction of any goodwill amortization, more closely reflect microeconomic reality as we appraise it.

More details with respect to CORT are contained throughout this annual report, to which your careful attention is directed.

CORT has long been headed by Paul Arnold, age 57, who is a star executive as is convincingly demonstrated by his long record as CEO of CORT. We are absolutely delighted to have Paul and CORT within Wesco. We continue to expect a considerable expansion of CORT's business and earnings at some future time.

Precision Steel Warehouse, Inc. ("Precision Steel")

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, operated at an after-tax loss of $.9 million in 2003, versus an after-tax profit of $.3 million in 2002. The 2003 figure reflects $.7 million, after taxes, expensed in connection with environmental cleanup of an industrial park where a Precision Steel subsidiary has operated alongside approximately 15 other manufacturers for many years. Had it not been for the environmental matter or for LIFO inventory accounting adjustments, Precision Steel would have reported an operating loss of $.2 million, after taxes, for 2003, versus after-tax profits of $.1 million for 2002. We do not regard earnings changes from environmental cleanup or LIFO accounting adjustments, up or down, as material in predicting future earning power.

The U.S. steel industry has generally been a disaster since 2000, and Precision Steel has suffered worse effects than occurred for it in previous general declines in the U.S. steel business.

Precision Steel has suffered a significant reduction in demand for steel combined with intensified competition above the fierce level encountered in each prior year. Some of the sales reduction is caused by customers' (or former customers') unsuccessful competition with manufacturers outside the United States. The severity of the domestic downturn is demonstrated by the fact that Precision Steel's average annual steel service revenues for the years 2001 through 2003 were down 27% from those reported for 1998 through 2000. It has not reported satisfactory operating results in recent years; ignoring environmental-cleanup costs and LIFO adjustments, its approximately-break-even operations for 2002 and 2003 compare very unfavorably with operating profits which averaged $2.3 million, after taxes, for the years 1998 through 2000. Very recently, the cost of Precision Steel's raw materials rose sharply in price.

Supplies of steel, which have generally been available to Precision Steel, are no longer easy to obtain. The market has drifted into near chaos caused by shortages. It is not clear how this is going to work out. Early in 2004, prices and profits are higher at Precision Steel, but longer-term effects are far from clear.

Terry Piper, who became Precision Steel's President and Chief Executive Officer late in 1999, has done an excellent job in leading Precision Steel through difficult years.

Tag Ends from Savings and Loan Days

All that now remains outside Wes-FIC but within Wesco as a consequence of Wesco's former involvement with Mutual Savings, Wesco's long-held savings and loan subsidiary, is a small real estate subsidiary, MS Property Company, that holds tag ends of appreciated real estate assets with a net book value of about $6.4 million, consisting mainly of the nine-story commercial office building in downtown Pasadena, where Wesco is headquartered. MS Property Company's results of operations, immaterial versus Wesco's present size, are included in the breakdown of earnings on page 1 within ''other operating earnings.''

Other Operating Earnings

Other operating earnings, net of interest paid and general corporate expenses, amounted to $.4 million in 2003 and $.6 million in 2002. Sources were (1) rents ($3.2 million gross in 2003) from Wesco's Pasadena office property (leased almost entirely to outsiders, including Citibank as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiaries, less (3) general corporate expenses plus minor expenses involving tag-end real estate.

Consolidated Balance Sheet and Related Discussion

Wesco carries its investments at market value, with unrealized appreciation, after income tax effect, included as a separate component of shareholders' equity, and related taxes included in income taxes payable, in its consolidated balance sheet. As indicated in the accompanying financial statements, Wesco's net worth, as accountants compute it under their conventions, increased to $2.1 billion ($292 per Wesco share) at yearend 2003 from $1.96 billion ($275 per Wesco share) at yearend 2002. The main cause of increase was net income after deduction of dividends paid to shareholders.

The foregoing $292-per-share book value approximates liquidation value assuming that all Wesco's non-security assets would liquidate, after taxes, at book value.

Of course, so long as Wesco does not liquidate, and does not sell any appreciated securities, it has, in effect, an interest-free ''loan'' from the government equal to its deferred income taxes on the unrealized gains, subtracted in determining its net worth. This interest-free ''loan'' from the government is at this moment working for Wesco shareholders and amounted to about $32 per Wesco share at yearend 2003.

However, some day, parts of the interest-free ''loan'' may be removed as securities are sold. Therefore, Wesco's shareholders have no perpetual advantage creating value for them of $32 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than $32 per Wesco share.

Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway. Moreover, the quality disparity in book value's intrinsic merits has, in recent years, continued to widen in favor of Berkshire Hathaway.

All that said, we make no attempt to appraise relative attractiveness for investment of Wesco versus Berkshire Hathaway stock at present stock-market quotations.

To progress from this point at a satisfactory rate, Wesco plainly needs more favorable investment opportunities, recognizable as such by its management, preferably in whole companies, but, alternatively, in marketable securities to be purchased by Wesco's insurance subsidiaries. Our views regarding the general prospects for investment in common stocks are unchanged one year after Warren Buffett wrote the following, in his 2002 annual report to shareholders of our parent company:

> ''We continue to do little in equities. [We] are increasingly comfortable with our holdings in [our] major investees because most of them have increased their earnings while their valuations have decreased. But we are not

inclined to add to them. Though these enterprises have good prospects, we don't yet believe their shares are undervalued.

''In our view, the same conclusion fits stocks generally. Despite three years of falling prices, which have significantly improved the attractiveness of common stocks, we still find *very* few that even mildly interest us. That dismal fact is testimony to the insanity of valuations reached during The Great Bubble. Unfortunately, the hangover may prove to be proportional to the binge.

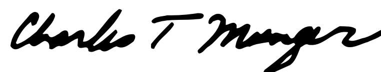
''The aversion to equities that [we] exhibit today is far from congenital. We love owning common stocks — if they can be purchased at attractive prices. In [my] 61 years of investing, 50 or so years have offered that kind of opportunity. There will be years like that again. Unless, however, we see a very high probability of at least 10% pre-tax returns (which translates to 6½-7% after corporate tax), we will sit on the sidelines. With short-term money returning less than 1% after-tax, sitting it out is no fun. But occasionally successful investing requires inactivity.''

In fact, the one thing that should interest Wesco shareholders most with respect to 2003 is that, as in 2002 and 2001, Wesco found *no* new common stocks for our insurance companies to buy.

The Board of Directors recently increased Wesco's regular dividend from 33½ cents per share to 34½ cents per share, payable March 3, 2004, to shareholders of record as of the close of business on February 4, 2004.

Wesco now has a website: www.wescofinancial.com. Shareholders can there access much Wesco information, including printed annual reports, earnings releases, SEC filings, and the websites of Wesco's subsidiaries and parent, Berkshire Hathaway.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.



Charles T. Munger
Chairman of the Board

March 4, 2004

Notes from the 2004 Wesco Annual Meeting

May 5, 2004
Pasadena, CA

By Whitney Tilson
WRTilson@T2PartnersLLC.com
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Notes: This is not a transcript. Recording devices are not allowed at the meeting, so this is based on many hours of rapid typing, combined with my memory (egads!). I have reorganized the content of the meeting by subject area. All quotes are Munger's unless otherwise noted. Words in [brackets] are my comments or edits, and all web link insertions are mine.

For more on this meeting, see my 5/7/04 column, Charlie Munger In Rare Form. To read my columns and notes from previous Berkshire and Wesco meetings, click here. Links to all of my published columns are here.

OFFICAL MEETING

[The official business of the annual meeting is generally wrapped up in five minutes, with Munger calling for approval of directors, etc. He said, "All those in favor, say "Aye." (Audience: "Aye") All those opposed? (Audience: silence) Those people may leave. (Laugher)]

OPENING SPEECH

[After the official affairs of the meeting are taken care of, Munger always gives an opening speech. Unlike previous years, however, it went on for nearly an hour. I had trouble typing fast enough to keep up, so my notes are a little spotty in places.]

What Explains the Phenomenon of Berkshire's Annual Meeting?
This of course is the aftermath of the Berkshire meeting held in Omaha four days ago. 19,500 people were there, packed to the gills in the main arena, plus 2,500 or more in a separate room with video.

When something as unusual as that – 19,500 shareholders at a meeting, and everyone having a whee of a time – you might ask two questions: What the hell is going on here? and Why did it happen?

What's going on of course is that alone among all companies in the history of the capitalist world, Berkshire has created an annual meeting that has cult-like attractions – attractions that attract an enormous number of people. It's like Chautauqua [an area in upstate New York where there a various cultural and educational activities; here's a link to the Chautauqua Institution]. There are parties and all sort of other events, as well as discount shopping (on which Berkshire makes a substantial profit because we have so many subsidiaries).

The reason this thing happens is because there's a value system at Berkshire – and also at Wesco – and that value system is really adored by shareholders. It's partly because people are so mad at the rest of corporate America – which is not so flattering – and partly because we've been around for so many years and made a lot of money, of course. But IBM made more money for shareholders back in its heyday from [the stock's] bottom to top, yet people didn't flock to its meetings, even though it had a widely admired culture.

Berkshire has created this system, and the intellectual content has been limited to a fairly short catechism: low pay for the people at the top and a high sense of duty. A lot of shareholders trusted us when we were young and in many cases it was almost all of their money. So our shareholders were not represented by analysts; we know a lot of them personally. It's hard to love a group of analysts working for institutions. The analysts who are here are not from institutions; they're oddballs like us.

The typical analyst would sell his mother to get another 10 cents in earnings per share so the stock would pop and he would look good. The analysts who represent institutions are not liked by CEOs – but the CEOs of course are smart enough not to let on.

A lot of [corporations' annual] meetings are set up to avoid groups like you – they're in inconvenient locations and at inconvenient times – and they hope people like you won't come.

Not just shareholders attend the Berkshire annual meetings. People from our subsidiaries come and bring their families. It's enormously valuable. It wouldn't work with just discount shopping. It takes ethos. In that sense we're cult-like and like a religion.

So we try to run this [in a certain way]. We don't hire compensation consultants or financial relations people, and there's no [in-]house [legal] counsel (not that there's anything wrong with house counsel).

Lou Vincenti [former Chairman of Wesco; briefly mentioned in Buffett's 1977 and 1979 annual letters], who used to sit here, said, "If you tell the truth, you don't have to remember your lies." [Laughter]

We don't care about quarterly earnings (though obviously we care about how the business is doing over time) and are unwilling to manipulate in any way to make some quarter look better. So that's a very different ethos.

When it comes to intellectual content, we try harder to be rational and ethical and not be abusive. Now, with 175,000 employees at Berkshire, I'll bet one of them is doing something I wouldn't like right now, but overall Berkshire has been remarkably free of scandal over the decades.

I think these things [referring to well-attended annual meetings] happen when 3-4 things work together. I don't think it would happen if Warren and I didn't have a significant wise-ass streak. To sit for six hours – people wouldn't do it without this. [Laughter]

With this sense of ethos, people sense we're trying to do it right. We don't have an isolated group [of senior managers] surrounded by servants. Berkshire's headquarters is a tiny little suite. We just came back from Berkshire's board meeting; it had moved up to the board room of the Kiewit company and [it was so large and luxurious that] I felt uncomfortable.

Long ago, every S&L [Savings & Loan like Wesco] had big, luxurious offices built, but Louie just made his own office extra large for board meetings. He wasn't about to pay for an extra room.

Many companies have financial counselors. Many hope they'll learn something. If one guy won 50% of all bass fishing tournaments, and he had a talk on how he twisted the reel, a lot people would come. I think our meetings are a big source [I missed this – I think he talked about how people come to Berkshire meetings for similar reasons: to learn how Buffett and Munger have had so much success].

The Wesco meeting of course gets the hard-core nutcases. [Laughter] There's a little group that comes locally, but the rest come from far away – some come from Europe. Like the Catholic catechism, we don't have much new to say, but like the Catholic priesthood, we just say the same old catechism.

Investment Philosophy

We don't believe that markets are totally efficient and we don't believe that widespread diversification will yield a good result. We believe almost all good investments will involve relatively low diversification.

Maybe 2% of people will come into our corner of the tent and the rest of the 98% will believe what they've been told [e.g., that markets are totally efficient, etc.].

Investing as Taught By Academia

We've had very little impact. Warren once said to me, "I'm probably misjudging academia generally [in thinking so poorly of it] because the people that interact with me have bonkers theories." Beta and modern portfolio theory and the like – none of it makes any sense to me. We're trying to buy businesses with sustainable competitive advantages at a low – or even a fair price. [The reason the professors teach such nonsense is that if they didn't], what would they teach the rest of the semester? [Laughter] Teaching people formulas that don't really work in real life is a disaster for the world.

At Stanford, Jack McDonald is the most popular professor at Stanford business school [he teaches a value investing course rooted in Graham/Buffett/Munger principles]. He teaches a double course load, yet still his courses are oversubscribed and he is voted the most popular teacher, yet they can hardly wait for Jack to leave [I assume Munger is referring to other finance professors, because what McDonald is teaching is so threatening to what they're teaching]. [Laughter] I'm not making this up.

[For more on Jack McDonald, I've posted Chapter 4 (with his permission, of course) from my friend Andy Kilpatrick's outstanding book, Of Permanent Value: The Story of Warren Buffett/More in '04, California Edition, which I highly recommend.]

Berkshire has never believed in extreme diversification.

Moral Code
We believe there should be a huge area between everything you should do and everything you can do without getting into legal trouble. I don't think you should come anywhere *near* that line. We don't deserve much credit for this. It helps us make more money. I'd like to believe that we'd behave well even if it didn't work. But more often, we've made extra money from doing the right thing. Ben Franklin said I'm not moral because of it's the right thing to do – but because it's the best policy.

Berkshire's and Wesco's Cash Hoard and Valuations
Berkshire and Wesco are full of cash that we don't know what do with. Berkshire has $70 billion if you count the bonds, and Wesco is drowning in cash. It's the most extreme it's ever been. In the past, we've just been patient and we were able to put it to work.

In the early days, Wesco had $40 million in book value, and it's now $2 billion – and the market value is 20-30% above book. This is ridiculous. [A premium to book] happened in Ben Graham's closed-end fund, which traded for 120% of liquidation value. I never would have paid this. But Ben Graham bought control of GEICO, which wasn't legal, so when he realized it, he distributed the stock to shareholders, and people who paid 120% [of book for the fund] and held it [the GEICO stock], did extremely well.

I can almost promise you that there will not be a similar result here. [Laughter] We're too big and too old. [Laughter] But I hope we will do credibly. I don't think we'll do badly, and given that I don't see much else out there that's attractive, [I missed this, but basically he said that investors in Wesco (he might also be referring to Berkshire investors) might well do better than the average investor, given how overpriced nearly all types of assets are].

If you're locked into a security [like Wesco stock], there are worse things. If you want to create a cult, you gotta expect you'll pay some consequences. [Laughter]

How Has Berkshire Succeeded?
How does a little company in the textile business, sure to go blooey, [succeed on such a massive scale?] Textiles are [little more than] congealed power, so if Warren had just stayed in the textile business, he would have been sure to go bankrupt. But he wrung a little money out of it,

invested it in insurance and many years later, a business with a $10 million market cap become one with $100 billion – and there aren't a lot more shares outstanding.

How did this happen? If you took the top 15 decisions out, we'd have a pretty average record. It wasn't hyperactivity, but a hell of a lot of patience. You stuck to your principles and when opportunities came along, you pounced on them with vigor. With all that vigor, you only made a decision every two years. We do more deals now, but it happened with a relatively few decisions and staying the course for decades and holding our fire until something came along worth doing.

Master Plans
And there has never been a master plan. Anyone who wanted to do it, we fired because it takes on a life of its own and doesn't cover new reality. We want people taking into account new information.

It wasn't just Berkshire Hathaway that had this attitude about master plans. The modern Johns Hopkins [hospital and medical school] was created by Sir William Osler. He built it following what Carlyle said: "Our main business is not to see what lies dimly in the distance but to do what lies clearly at hand."

Look at the guy who took over the company that became IBM. At the time, it had three equal sized business: [a division that made] scales, like those a butcher uses; one that made time clocks (the bought this for a block of shares, making an obscure family very rich); and the Hollerith Machine Company, which became IBM. He didn't know this would be the winner, but when it took off, he had the good sense to focus on it. It was enlightened opportunism, not some master plan.

I happen to think great cities develop the way IBM or Berkshire did. I think master plans do more harm than good. Anyway, we don't allow them at Berkshire, so you don't have to worry about them.

Outlook
I don't have the slightest glimmer that things are getting a lot better [in terms of investing all of Berkshire's and Wesco's cash]. It's still a world awash in cash. Every university has to have a fixed income arbitrage department, a leveraged buyout department, a department for small cap investing, mid-cap investing, and so forth – and consultants to tell them what do with it all. There's enormous manpower to shuffle paper. But anyway, that's where we live in the culture.

Scandals
One thing that people ask about is the enormous amount of scandal. This isn't new – there's a lot of historical precedent. You can go back to Jay Gould – there was a lot of misbehavior by the robber barons, though they did some good too.

[In recent years,] We've had an enormous amount of corporate misbehavior, and it's affected the lawyers, accountants and investment bankers (though they never used to behave well).

Where will it stop? Royal Dutch Shell was about the best: it had a rigid meritocracy comprised mainly of excellent engineers. And to have the lying about the reserves become so extreme that the #2 guy creates a written record when he tells the top guy he's tired of lying about the reserves – [when this happens at a company like Shell], I can guarantee you [that corporate misbehavior] is widespread. When everyone [every CEO] becomes Jack Welsh, [who managed GE] to have income go up steadily [it's a bad thing]. [GE under Welsh was notorious for managing the natural volatility if its earnings so show investors a false picture of steadily rising profits.]

[Part of the problem is that] The time horizon is wrong. The guy who fudged the reserves [at Shell] was near retirement, so [the accounting games] only had to last 3-4 years. The time horizons of CEOs are wrong.

And it's not just CEOs – the people investing the pension plans of municipalities have done terrible things. And the pension plans of police departments [my notes are weak here; I think he talked about how the pension plans are gamed by retiring cops working a lot of extra hours in their last year, which translates into much higher pension payouts]. No-one has the least sense of shame; [they rationalize that] everyone else does it…

Demise of Ethics Among the Major Accounting Firms

When I was younger, the senior partners at the major accounting firms were Scottish – more than half were. And they were quite ethical places and nobody got filthy rich – I know because I handled some of their estates. The were many Indians and few chiefs.

But in the space of 25 years, they sold out to terrible behavior, one little step at a time. Once you start doing something bad, then it's easy to take the next step – and in the end, you're a moral sewer. The idea that the major accounting firms of the country would sell obviously fraudulent tax shelters... [Their strategy was to] make it so obscure that it won't be caught. One after another, the accounting firms went into it. And the lawyers got paid big feels. I don't know where it would have stopped had the scandal not hit. Deloitte has cashiered all of its culpable tax partners, but they waited until it was obvious – they should have acted sooner. It was the same at the other accounting firms.

[I spoke with Wesco's auditor from Deloitte, who was on stage with Munger at the meeting, and he took issue with Munger's characterization of his firm, saying that Deloitte was alone among the big accounting firms in not pushing abusive tax shelters. (But he said he loved everything else Munger had to say!)]

J.P. Morgan Chase set up something in the Canary Islands to avoid taxes. What the hell were they thinking? [I missed some of his rant here – but it was a good one!]

To a guy who's a Republican like me, [all of this bad behavior – I think he's referring to behavior across corporate America, not just accountants] is awkward because they [the perpetrators] were all Republicans. [Laughter]

I do think we're coming back from that. When the guys went to the penitentiary to pound rocks for price fixing, I think it changed [that type of behavior]. I think a goodly number of people

going to prison will help things. But there are enormous pressures. There's so much money [at stake], and it's easy to report a little more [in earnings, to keep the stock price up]. I don't think we've seen the last person to succumb to the temptations.

Impact of Sarbanes-Oxley

I think you'll even get some bad things from Sarbanes-Oxley. Some people will have a really good quarter, and they formerly wanted to be conservative, but under their impression of Sarbanes-Oxley, they will make a wrong call [and not be as conservative as they otherwise would be].

There's nothing wrong with conservatism, as long as it's consistent. Reporting more earnings when the business is weak and less when it's strong – that's obviously wrong. The world would be better if everybody was consistently conservative, but we're a long way from that result.

[I was initially confused by these comments because being excessively conservative is hardly a problem in Corporate America – though some companies do use "cookie-jar" accounting to smooth earnings. A friend of mine thinks that what Munger is really talking about is the impact on Berkshire (and the few other companies that are as conservative as Berkshire is). Let's say Berkshire was extremely conservative and set aside $3 billion (he's making up this number) in reserves for World Trade Center losses. In past years, my friend argues, if it turned out that losses were only going to come in at $2 billion, then Buffett and Munger would say to themselves, "Well, let's keep the extra $1 billion in reserves, rather than running it through the income statement as unexpected profit, just to be extra conservative and because we're sure to get hit with surprises on other policies that we haven't reserved for at all." Now, under Sarbanes-Oxley, Berkshire can no longer be extra conservative like this, which Munger surely thinks is a bad thing.]

Signs of Hope – New Zealand Example

There are a lot of hopeful signs – and this ought to cheer up Republicans. New Zealand over time developed socialist systems – it had every sign you could image of socialism gone mad: import barriers, high unemployment, big deficits, high taxes, big government, etc. But in now has low taxes, a flat 10% consumption tax, a budget surplus, reduced debt, and so forth. The school system was a disaster, but in one fell swoop they revised it the way Milton Friedman would like. And this was led by the Labor Party!

So, at least there's some hope somewhere where a highly socialist system like New Zealand can change. And the change was dramatic – it made what Margaret Thatcher did in the UK look like nothing. New Zealand took folly by its neck and wrung it out. It took one department, the works ministry, and cut [all of its staff] to one person. They just hired private firms to do it.

They had terrible unemployment – nobody was working. That's what caused the Labor party to say, "We're this tiny little island, nobody's working, so we have to fix it."

But the scandal and dysfunction has to get very extreme before someone will do something.

Workman's Comp
Take Workman's comp in California – to say it was sinful is an understatement. It had crooked chiropractors, lawyers, legislators, etc. It was a miracle that we got 20% of the reform that we needed – we needed a recall [of the governor], threats from Schwarzenegger, etc. [to make it happen].

So it happened, and we do get reform, so my guess is that we'll see some of the worst behavior in modern business dissipate.

Lawyers
The lawyers have escaped most criticism [and undeservedly so]. The tax shelters [were approved by lawyers, who got paid huge commissions to do so] and every miscreant had a high-falutin' lawyer at his side. Why don't more law firms vote with their feet and not take clients who have signs on them that say, "I'm a skunk and will be hard to handle?" I've noticed that firms that avoid trouble over long periods of time have an institutional process that tunes bad clients out. Boy, if I were running a law firm, I'd want a system like that because a lot of firms have a lot of bad clients.

Martha Stewart
What happened with Martha Stewart was that she heard some news, panicked and sold the stock. It turns out that if she's just told the truth [about what she did], she'd have been OK, but because she had a vague idea that what she'd done was wrong, she had a totally phony story when the investigators came and she lied to them and that's a felony. And she did these acts *after* she'd hired high-fallutin' lawyers! And I'm sure they charged her a lot. [Laughter] I do not invent these stories.

Were I her lawyer, I would have said, "You know Martha, that's an interesting story and I'm your lawyer, so I'm required to believe you, but nobody else will. So, you're going to have to come up with a different story or you'll have to tell it through a different lawyer because I don't like losing cases." [Laughter] And it'll work. It's so simple. Literally, she's going to prison for her behavior *after* she'd hired a lawyer!

Tell the Truth
Look at Bill Clinton and the Paula Jones case. Because he lied, he lost his license to practice law, which is a significant disgrace for a sitting President of the United States. I would have advised him to just settle.

It's everywhere you turn. Remember Louis Vincenti's rule: "Tell truth and you won't have to remember your lies." It's such a simple concept.

Imagine what it was like in third or fourth year [after the lying about reserves had begun] at Shell. What seemed like a good idea in year one is getting really uncomfortable. You [the CEO] have been knighted by the Queen and you don't want to admit that reserves went down a bit. What's wrong with that? Why get your ego involved?

These things happen over again and the plots are very similar – they come back time after time.

Bad Behavior in the Money Management Industry
I feel obligated to ramble a bit when people have traveled so far. [Laughter]

I have one more anecdote: I have fun with this when I speak in front of students and professors. I say, "You all understand supply and demand curves. If you raise price, you sell less, but make more margin. So, give me four instances where the correct answer is to raise the price [meaning volume will go *up*]." I've done this about four times, and maybe one person in 50 can give me one answer that's correct.

I can easily name four or five: Say you sold widgets to company X, and then raised your prices, but used some of the proceeds to bribe the purchasing agent for X. [For an example of this,] Look at the mutual fund industry. Many mutual funds pay a 5% commission [load on the fund] to buy their mutual fund instead of other securities or funds. So, in substance, they're really bribing the purchasing agent [the purchasing agent is the financial advisor who receives the bribe/kickback from the mutual fund company to which he steered his clients' assets]. [Munger added, however, that:] Many people [referring to the fund companies that pay the bribes] behave well once they're over this.

But not always. Can you *imagine* the people who mutual fund taking a bribe to steal from their own clients?! This is not a minor sin. I think Chris Davis [of Davis Funds] is here. At his shop, when they came in and offered [to invest] $40 million [in the Davis Funds in exchange for] allowing [abusive] trading, it went through two layers before someone said, "This is crazy!" [I think Munger is praising the Davis Funds – a great value-oriented firm that I'm sure Munger admires – for making the right decision, though I'm sure everyone agrees that the right decision should have been arrived at instantly.]

It's as if someone approached you and said, "Let's murder your mother and split the life insurance proceeds 50/50," and you saying, "Well, I have other siblings [so losing my mom wouldn't be so bad], and I'm not sure 50/50 is fair, but let's do it." [Laughter]

It was not only immoral, but stupid. Imagine you're as rich and successful as Dick Strong was, and then stealing $500,000 more?

I think that will get a lot better. We really ended up with something in the mutual fund business that we didn't intend. [I missed some here; he talked about how the industry was originally set up by investment counseling operations.] If mutual fund directors are independent, then I'm the lead character in the Bolshoi Ballet. [Laughter]

I don't think management companies should be allowed to sell [their] mutual funds. I think Capital Guardian took the high moral ground [I'm not sure what he's referring to]. But if you spent so much time building it, and everyone else is doing it…[of course they're going to want to sell it].

QUESTION & ANSWER PERIOD

COMMENTS ON WESCO

Intrinsic Value of Berkshire and Wesco
Berkshire has more in intrinsic value per dollar of book value than Wesco, and the gap is widening. I've written that many times. It's easy to calculate the intrinsic value of Wesco, but hard to do so for Berkshire. You'll have to do this yourself.

What If Munger Dies?
As you can tell, we're planning on immortality here. [Laughter] What do you need – [isn't it enough that we're] sitting on a pile of money and Warren Buffett [is] sitting at the parent corporation?

Quant Tech
[At the 2001 Wesco annual meeting, Munger passed out a booklet entitled "Some Investment-Related Talks and Writings Made or Selected by Charles T. Munger," which contained a number of articles and writings by Buffett and Munger. One of the essays in the handout was entitled "The Great Financial Scandal of 2003." It's a story Munger wrote – that I think loosely resembles Cisco, IMB and the like – in which the managers of a formerly reputable tech company become greedy, start giving themselves vast numbers of stock options and cooking the books, and it eventually all comes crashing down. Asked to comment on this, Munger said:]

It wasn't hard for a person with any mathematical training to see the scale to which the misleading was possible. All I did in that story was escalate the scale using the accounting conventions. Of course, since I was writing the story, I could punish the miscreants. I sent the accountants to the lowest rung of hell – they were the custodians of a great profession (whereas we expected the investment bankers to behave terribly). Remember that traders occupy the lowest rungs of hell. The accountants who lived in the nice neighborhoods [who sold out] were sent to join the traders. It's fun sending people to where you think they belong. I had a lot of fun writing that story.

Cort
Cort has blipped a little tiny bit back from the pit. Obviously, our timing was terrible. I don't see how we could have had worse timing if we'd tried to have bad timing. But it will work out OK over time.

Wesco Movie
[A shareholder asked, tongue-in-cheek, when there would be a movie at the Wesco annual meeting.]

There will *never* be a Wesco Corporation annual meeting movie. [Laughter]

COMMENTS ON BERKSHIRE HATHAWAY & ITS SUBSIDIARIES

Munger's Impact on Buffett
I think those authors give me more credit than I deserve. It is true that Warren had a touch of brain block from working under Ben Graham and making a ton of money – it's hard to switch from something that's worked so well. But if Charlie Munger had never lived, the Buffett record would still be pretty much what it is.

What Happens When Buffett's Gone?
When Warren is gone, the acquisition side of Berkshire will not do as well, but the rest will do well. And the acquisition side will do just fine. In any case, we've guaranteed you that the historical rate of growth will go down, and we wouldn't want to make a liar out of me. [Laughter]

[Later in the meeting, Munger returned this topic:]

I think the top guy won't be as smart as Warren. But it's silly to complain: "What kind of world is this that gives me Warren Buffett for 40 years and then some bastard comes along who's worse?" [Laughter]

Danger of Losing Berkshire's Corporate Culture?
[One shareholder asked about the danger of Buffett's descendents being outflanked by professional managers who destroyed the culture, as happened at Disney and Hewlett-Packard?]

I am not worried about the Munger family having a huge concentration in Berkshire stock long after I'm dead. I think Berkshire's culture will last, just as Wal-Mart's culture has lasted for 15 years after Sam Walton's death. There are some real similarities, including roughly similar percentage ownership levels by the families.

I can't be responsible for the conduct of my heirs – I have enough difficulty being responsible for my own conduct, so I don't want to be blamed for my children. And for my nieces and nephews [and more distant descendants], I *really* don't want to be blamed. [Laughter]

I think Berkshire has a *way* better chance of maintaining its culture than just about any company. I think we're way more like Wal-mart than Disney. I think we won't lose the culture – that it'll last a long, long time.

Comments on Gen Re
Regret Purchase of Gen Re?
Shortly after acquiring Gen Re, of course, we soon came into adverse developments, including the happenstance of the World Trade Center events. But we also found that the culture was weaker that we thought. But we're delighted now and it's fixed.

I don't know where we'd get a Gen Re now, like the Gen Re we have, if we wanted one, so I'm not gnashing my teeth. We bought at the peak of the market, sold everything [Gen Re's stock holding], took losses, and we now we have the capital asset. So it made us look silly for a while,

but in the long game for Berkshire, the bad part was a blip and the long-term looks quite favorable.

Comparative Merits of Gen Re vs. Other Reinsurers
I don't like to appraise the comparative merits of other reinsure companies because we do business with them all the time, but the problem I have is that in my heart of hearts, I like my business so much better than theirs.

Flight to Quality in Reinsurance?
There's obviously been some flight to quality in reinsure, but I'd call it more of a dribble to quality. [Laughter]

Impact of Judge's Ruling on How Much Insurers Have to Pay Larry Silverstein, the Developer of the World Trade Center Site
[Missed this – it was a quick answer; something about multiple verdicts expected and that based on the first verdict, Gen Re's share was $109 million.]

Gen Re's Declining Volumes and Loss of Market Share
[Munger asked Gen Re's CEO, Joe Brandon, to answer this question. Brandon said:]

There's no doubt that Gen Re's share of North American premium volume has gone down in the last few years. That's because we've had a deliberate focus on profitability. We've made no macro calls on which lines [of insurance or reinsurance] we want to be in. We underwrite the transactions one at a time, only doing what makes sense. If they don't make sense, we just say "no thank you" and don't write the business. We have no premium volume or market share goals. I expect the premium volume will be down again, modestly, in 2004.

From 1986 to 1988, Gen Re's premiums declined by about 28%. From 2001-2004, it will likely be similar before it bottoms out -- it's impossible to predict for sure. We are not focused on share, but profitability.

Munger: "The tone of your question implied that it's terrible that we're losing share, but you'd be out of your mind to focus on share as opposed to profitability.

[After the meeting, Brandon talked with a group of shareholders about the efforts to change Gen Re's culture from one focused on premium growth to one not caring if premiums fell if the pricing wasn't right. The key, he said, is to convince people that their jobs are safe, even if they don't write as much business as they used to. He also tells them, "If we do nothing (i.e., don't write any business), we'll make almost $1 billion pre-tax this year, so we don't want to mess it up by being undisciplined in how we price and underwrite business." Overall, he said that the culture isn't entirely fixed, but he's pleased with the progress. He also noted that overall pricing in the insurance market, after rising strongly in recent years, has stopped rising, and, in some lines, has begun to fall. (These notes are included with Brandon's permission.)]

Coke's Future
Well, the nature of all remarkable growth rates is that they peak in due course. Personally, I don't think Coke has reached a peak in its volume, though perhaps in its growth rate. 10 years from now, I think they'll be selling more volume. It's a mature product, but its decline phase is *way* out there.

Clayton Homes Acquisition and Controversy
Regarding Clayton Homes, we did get a reaction that it was worth more [than what we offered], but that wasn't so. The Claytons knew more than we did. There had been so much disgrace and bad behavior by so many people in the industry that lenders weren't willing to lend to anyone in the sector, so even Clayton Homes, which is the class of the industry, was having serious problems making their business model work.

I suppose it's flattering that people think that if we're so smart [to buy Clayton at the price we did, then] we must be stealing, but it's not true. We paid a fair price.

Commissions Paid and Market Impact When Buying or Selling
On commissions, we pay under five cents per share. As for market impact, we generally don't try to buy thinly traded stocks. Is there market impact? That depends on what we're buying, but it's been so long since we've bought anything that it's like asking Rip Van Winkle about the past 20 years. [Laughter] We try not to have much market impact. There's a little art in this process.

Silver
We don't comment on what we're doing or whether we're still in it. If we know enough to beat the market over time, we know enough not to tell everyone, who could act in ways that might hurt us.

Do You Have Thoughts on How to Calculate the Intrinsic Value of Commodities Like Silver
No.

Home for Entrepreneurs
[Munger was asked what advice he would give if someone wanted to create another home for entrepreneurs (and their businesses) like Berkshire. He said he didn't know.]

HOW TO BECOME A BETTER INVESTOR

Keys to Investment Success
It's a common question – like the fellow who wins all the bass tournaments, to ask how did you jiggle the lure? Partly its temperament – most people are too fretful, they worry to much. Success means being very patient, but aggressive when it's time. And the more hard lessons you can learn vicariously rather than through your own hard experience, the better.

I don't know anyone who [learned to be a great investor] with great rapidity. Warren has gotten to be one hell of a lot better investor over the period I've known him, so have I. So the game is to keep learning. You gotta like the learning process.

You seem to like learning a lot. But I'd inject one line of caution: there's an apocryphal story about Mozart. A 14-year-old came to him and said, "I want to learn to be a great composer." And Mozart said, "You're too young." The young man replied, "But I'm 14 years old and you were only eight or nine when you started composing." To which Mozart replied, "Yes, but I wasn't running around asking other people how to do it." [Laughter]

Proper Thinking
Einstein was reported to have said, "Everything should be made as simple as possible, but no more simple." If he didn't say it, he should have.

And another thing: Thinking success comes from four things [I missed one]: curiosity, perseverance, and self-criticism. Any year that passes in which you don't destroy one of your best loved ideas is a wasted year.

[I missed this. He quoted Philip Wiley (?) saying something about there's nothing you can squeeze between what you know and what you want to know…(?)] You want a guy who can destroy his well-loved ideas.

Investing Overconfidence
Most people who try it don't do well at it. But the trouble is that if even 90% are no good, everyone looks around and says, "I'm the 10%."

BUSINESS AND INVESTING TOPICS

Are Any Asset Classes Undervalued?
Our cash is speaking for itself. If we had a lot of wonderful ideas, we wouldn't have so much cash.

Concerns About Consumer Debt
Gigantic macroeconomic predictions are something I've never made any money on, and neither has Warren. Of course I'm troubled by huge consumer debt levels – we've pushed consumer credit very hard in the US. Eventually, if it keeps growing, it will stop growing. As Herb Stein said, "If something cannot go on forever, it will stop." When it stops, it may be unpleasant. Other than Herb Stein's quote, I have no comment. But the things that trouble you are troubling me.

Channel Stuffing
The channel stuff in the soda [pop] industry, where it has occurred, has not been [having excess inventories] at end of the aisles in supermarkets, because the supermarkets would not allow this. Where it's occurred has been in excesses concentrate sent to the distributors. With Gillette, it was excess razor blades sent to distributors.

A lot of channel stuffing in America was done to make quarterly numbers. I think it's gone way down compared to its earlier times, and I think this is to the good – it was a very pernicious practice. It happened because CEO's said, "I'm a steward of shareholders and by moving things out a quarter [e.g., stuffing the channel], I can report better earnings, so I'm obligated to do it. I think that's changed a lot. It's less common now, though I think there was a recent case in ethical drugs [I think he's referring to Biovail]. It's a pernicious practice.

Asbestos
I don't think only allowing the truly sick to sue is politically viable, which is why we don't have a settlement. There's so much money in the system that you don't get a sensible solution. 70-80% of the money doesn't go to the people who have been injured. It's a crazy system. The guy who has mesothelioma gets a little bit [of money], and the guy who has nothing wrong with him gets way more than he deserves, along with his dishonorable doctor and lawyer.

And the subornation of perjury is a disgrace. The people who are left [the companies who have not yet gone bankrupt] had no moral fault at all – their products caused no damage, but they're the few people left solvent, so if you want to make money, you find guy with a spot on his lung, get him to testify that he spends his life worrying cancer, that it's ruining his life, and that of the 50 brand names, he only remembers the three brand names of the companies that happen to be solvent today. It creates behavior that's beneath contempt. Most of these claimants were smokers, so the net incremental damage [caused by asbestos] was between zero and trivial. It's a total disgrace, but there's so much money that there's no way to stop it. The politicians say that if we took enough money from Gen Re and its ilk, we'd solve the problem. But if you take money from Paul to pay Peter, but you just create more Peters – it's like dousing a fire by pouring gas in it. I predict it goes on and on and on.

Impact of Baby Boomers
Regarding the demographic trend called Baby Boomers, it's peanuts compared to the trend of economic growth. Over the last century, [our] GNP is up seven times. This was not caused by Baby Boomers, but by the general success of capitalism and the march of technology. Those trends were so favorable that little blips in the birth rate were not that significant.

We can keep social peace as long as GNP rises 3% annually – this can pay for spending by politicians. If we ever got to stasis [no growth], then with all the promises, you'd get real tensions between the generations. The Baby Boomers would exacerbate it, but the real cause would be lack of growth.

[When asked whether he thought growth would slow or cease, Munger said:] I don't think my prediction is any better than yours. There certainly been some remarkable technology. When I was young, there was no medicine for most diseases, no joint replacement surgery, etc.

The key is energy: in 100 years, if we get 3% growth worldwide – it's be higher in India and China – then I think we'll have to rethink how we use energy.

Independent Directors and Compensation
Generally speaking, if you're counting on outside directors to act [forcefully to protect your interests as a shareholder, then you're crazy]. As a general rule in America, boards act only if there's been a severe disgrace.

My friend Joe was asked to be on the board of Northwestern Bell and he jokes that "it was the last thing they ever asked me." [Laughter]

I think you get better directors when you get directors who don't need the money. When it's half your income and all your retirement, you're not likely to be very independent. But when you have money and an existing reputation that you don't want to lose, then you'll act more independently.

I'd argue that's the board we have at Berkshire and to a lesser extent at Wesco. Warren said to me once, "I think we may have the best board in the country" – and he wouldn't say it if he didn't believe it. They're awfully high grade people, and they're serving with little pay and no directors and officers insurance.

The best idea is to not pay [people to be directors at all]. I think tons of eminent people would serve on boards of companies like Exxon without being paid. The lower courts in England are run by unpaid magistrates. And Harvard is run by boards of people who don't get paid – in fact, they have to pay [in the form of donations to the school].

I think boards would be better if they were run like Berkshire Hathaway's.

It's incredible the reciprocity that happens when CEOs keep recommending that directors get paid more, and then the directors raise the CEO's pay – it's a big game of pitty pat. And then

they hire compensation consultants to make sure no-one else is getting paid more. This is true even is the CEO a klutz and a little dishonorable.

I think the existing system is very bad and my system would work better, but it's not going to happen.

Franklin said government would run better if no-one was paid. The Mormon church doesn't pay its clergy, but other than that…

Can Two Brands Co-Exist in a Market?
Obviously there are industries where two brands can co-exist like Ford and Chevrolet, but there are others like newspapers in one city where one brand tends to destroy the other. That's just the way it is. It's hard to predict what will happen with two brands in a market. Sometimes they will behave in a gentlemanly way, and sometimes they'll pound each other. I know of no way to predict whether they'll compete moderately or to the death. If you could figure it out, you could make a lot of money.

Under-Reserving in the Insurance Industry
It's a field where you get a fair amount of discretion on what you get to report. I would bet a lot of money that both Gen Re and Berkshire are *way* more conservative than average and will stay that way, even if they have terrible quarters to report. Generally speaking, I don't think you've seen the last scandal in insurance.

Derivatives
[I missed some of this, but he talked about how much money was involved, how much leeway people have in valuation positions, and the problems this raises.]

The real scandal will come in derivatives. Gen Re is running off its derivative book and we're seeing a lot of losses – far more than were stated.

I think a good litmus test of the mental and moral quality at any large institution [with significant derivatives exposure] would be to ask them, "Do you really understand your derivatives book?" Anyone who says yes is either crazy or lying.

Investment Advisors
The investment advisors who come to the Berkshire meeting are not a cross-section – we get the cream of the crop. Many have gotten rich [by following our teachings]. [I think I missed something in here.] Franklin said it's hard for an empty sack to stand upright.

Comments on Hedge Funds
Mine [the Munger Partnership] wasn't a hedge fund in legal terms. I had the power to go short, but I rarely did. In the last years, I didn't short anything.

Today, there are 8,000 hedge funds and the number is growing rapidly. There are hundreds of billions of dollars in them. Every university has to have hedge fund investments, and there are funds of hedge funds and layers upon layers of fees. There are hedge funds giving layers of

incentive fees to operating businesses beneath them. [I think he's referring to fund of funds charging fees on top of the already-high fees charged by the underlying hedge funds.]

I think you can confidently predict that per dollar year, all the hedge funds, for the hedge fund owners [meaning investors], after all fees and losses, they will not be moneymakers. In fact, the results will be somewhere between mediocre and lousy.

That being said, Berkshire has a hedge fund that's like a private fixed arb account. Some will do well. The trouble is, as someone once said about banks: "We have more banks than bankers." The problem is that there are more hedge funds than competent people to run them. Some hedge funds will do well no doubt.

I think it's very pernicious for the civilization that so much brainpower is going into hedge funds. Wesco is trying to build some property in Pasadena, and part of the reason we're doing it is that I don't want to be known a person who just bought and sold paper [securities/investments]. I would regards this as a failure. I want to be doing something to make civilization better.

Think about it. Would you really like it if all five of your children went into hedge funds, even if they were successful? Would you say to yourself, "Boy, I really hit it out of the park with these kids?" Wouldn't it be better if one was a surgeon, a lawyer, someone who rose through the ranks at Costco, and so forth?

It's amazing the brainpower being drawn into the hedge fund industry. When I was young, guys in the investment business were mediocre at best – they had eastern [East Coast] tailoring and didn't know very much. Now, it's a cascade of brainpower. Collectively, they add nothing to the GNP. Indeed, they're adding costs, collectively. If you take the money invested in common stocks, and then subtract the 2% per year that goes out in investment management costs and frictional trading costs, that's more than companies pay in dividends. It's more than the twin deficits. This would fit very well into Alice in Wonderland: pay dividends of X and pay the same amount to investment managers and advisors.

COMMENTS ON GOVERNMENT, REGULATORY & POLITICAL MATTERS

More on Sarbanes-Oxley
The pain [of so many scandals and trials] is helping to cleanse the system. But there's all this prejudice and ignorance in major power centers.

By no means everything that is done will improve matters. I don't think Sarbanes-Oxley is going to work very well. A CEO can't possibly attest to the veracity of the financial statements, as required by law, except by relying on other people. Now, if he was personally engaged in cooking the books, it's easier for the government to get him. If you took an extra $1 million in your expense account and then certified incorrect financial statements, it's easier to get him.

Dennis Kozlowski got so accustomed to taking so much, that one of the jurors said "He couldn't possibly have had criminal intent because there's no sense of shame." [Laughter]

Sarbanes-Oxley makes it easier to prosecute something like Martha Stewart.

Sarbanes-Oxley has raised our costs. I don't think it's done anything favorable for the quality [of our financial results], because there was quality to begin with.

Will it outsmart the crooks? I little bit. The incentives to fudge must be extreme if the head of Royal Dutch will fall into it. Passing Sarbanes-Oxley will not change it all that much. It will change it a little bit. Sarbanes-Oxley is not making it worse – it was terrible to begin with.

Congress Recent Relaxing Rules Requiring Companies to Set Aside Enough Money to Meet Pension Obligations
You had some very important institutions like airlines that couldn't pay their pension obligations, so Congress just papered it over by saying they didn't have to pay. Whether that's a good idea, I'll leave that up to you. It can't be a good sign for the civilization.

Recent Spitzer Inquiry Into Insurance Brokers
[I missed some of this.] A lot of the customers are big, sophisticated institutions who know the industry, so it's not like a little old lady trusting her broker.

Which Country Should America Emulate?
I still prefer this country, and so does Warren. But we're both troubled deeply by the twin deficits [trade and budget]. [Bad] Things can go on for a long time, starting from our [wealthy] base and especially if other counties have things wrong with them, so it's a very complex subject.

Iraq
Regarding Iraq, there are a lot of very intelligent people in this country that believe it was invading the country was totally stupid and that everything bad that's happened since then was totally predictable, and some believe that we should get the hell out.

All regret the loss of life and everyone concedes we overestimated the weapons of mass destruction risk, but a lot of people believe it was nevertheless worth it remove this terrible man that was so rich with so much hatred.

I don't think it was an easy decision – that's why so many intelligent people have such different views. It's not clear how it's going to work out and I don't have any special competence to predict this. But I think it's very wrong to assume that people on the other side are stupid and evil. If you're absolutely sure you're right, then you're probably committing a significant intellectual sin.

Schwarzenegger's Impact
Of course budgets in the real world are political compromises, and I don't think we've repealed that in California. But I think it's changed because Arnold Schwarzenegger became governor. Reforming Workman's comp is a huge step in the right direction, and it wouldn't have happened without the recall. So, overall I think Arnold Schwarzenegger has been good for California.

How to Fix the U.S. Healthcare System
I'm all for capitalism and the kind of cap that New Zealand went to, but I think that if you have a single payer system and an opt-out for people who want to pay more [for better service, etc.], I think it would be better – and I think we'll eventually get there. It wouldn't be better at the top – [our current system] is the best in the world at the top. But the waste in the present system is awesome and we do get some very perverse incentives.

Proper Tax Policy
My attitude toward taxes is that if I were running the world, we'd have a very substantial consumption tax, and the tax on earned income would be 40% at the top and taxes on long-term capital gains would be 20%.

And by the accident of history, we're not that far away from where we ought to be. I love consumption taxes – they're so effective. That that's why conservatives hate them – they work and the government gets a lot of money to spend.

In New Zealand, there's a national 10% consumption tax. Is it so bad to have to pay 10% extra if you go out for a nice meal or charter a plane? I don't worry about the miser who accumulates money and dies with it. What harm is he doing?

A 50% corporate tax rate would be too high. [I missed this. I think he said something about being fine on capital gains (?) and that 35% plus state taxes is just too high (for whom?)]. I'm not in favor of doing away with the 50% estate tax on people like me, but there should be a big exemption. Someone who builds a small business shouldn't be whacked, but there's nothing wrong with saying give 50% to society when you die if you've done really well.

My views would make me anathema in both parties.

Inflation Under Democracies
I think democracies are prone to inflation because politicians will naturally spend [excessively] – they have the power to print money and will use money to get votes. If you look at inflation under the Roman Empire, with absolute rulers, they had much greater inflation, so we don't set the record.

It happens over the long-term under *any* form of government. There was no inflation in the US from 1860-1914, and this period was accompanied by strong growth. I don't think we'll get deflation. The bias is way more pro-inflation than it was between 1860-1914. But I don't think other forms of government will necessarily do better. Some of the worst excesses occur under the tyrannies.

ADVICE ON LIFE AND OTHER

Things That Keep Munger Up at Night
Personally, I think the most important issue is still the threat that something really god-awful happens in terms of an atomic bomb or pathogens. It's so unpleasant to think about that people put it off, but if you think about what's likely to really spoil the party, that's far worse than a little inflation or one president vs. another.

What makes the Iraq thing so hard is that it's hard to know whether we're reduced or increased this risk [of a WMD attack]. But I don't think we want to have a lot of really rich countries in the hands of nuts full of hatred. I think the policy of sitting back and doing nothing is the wrong policy, because the nut will eventually do something awful.

The threat of bioterrorism and an atomic attack is still our worst problem. But people prefer to talk about Workman's comp and corporate malfeasance...

How to Teach Ethics
I think the best single way to teach ethics is by example: take in people who demonstrate in all their daily conduct a good ethical framework. But if your ethics slip and people are rewarded [nevertheless, then] it cascades downward. Ethics are terribly important, but best taught indirectly by example. If you just learn a few rules [by having ethics taught in school] so they can pass the test, it doesn't do much. But if you see people you respect behaving in a certain way, especially under stress, [that has a real impact].

Incentive Cause Bias
Incentive cause bias is widespread because it's routinely used in all compensation systems. If you're rewarding a man for believing his mutual fund is the best in the world and he needs the money to feed his family, he will believe this [however wrong]. Routine stuff creates incentive cause bias. It's good if you're a reputable institution. Take Mass General [the famed Boston hospital]: people who work there believe it's great institution – and this is good.

But there can be terrible effects for both good and ill. Think about those fraudulent accountants. I talked to one accountant, a very nice fellow who I would have been glad to have his family marry into mine. He said, "What these other accounting firms have done is very unethical. The [tax avoidance scheme] works best if it's not found out [by the IRS], so we only give it to our best clients, not the rest, so it's unlikely to be discovered. So my firm is better than the others." [Laughter] I'm not kidding. And he was a perfectly nice man. People just follow the crowd…Their mind just drifts off in a ghastly way…

I recall one story when Arco was celebrating making a lot of money on its oil fields. Their house counsel was an Irish guy who could get away with saying things, so he said: "I want to toast the guy who really deserves the credit for our success: Here's to King Faisal! All the predictions we made were wrong, costs were way over budget, etc. But along came King Faisal, who formed a cartel [OPEC], caused the price of oil to soar, and made us a fortune."

That is the kind of toast you seldom hear in corporate life, because it'll get you fired. But I love the kind of man who'll make a toast like that – a credit to the human race and an ornament to the civilization. Anyone who can join that [group], do so.

Deterioration in Union and Political Structure

I think we have enormous deterioration in union structure and political structure. [I missed this rant, but I think he referred to the union that represents prison guards in California, which has attained extraordinary political power and protects guards, allowing them to be abusive, which is especially worrisome since "I think the people who are attracted to be prison guards are not nature's noblemen to begin with." (Laughter)]

It's similar to the guards [who abused the prisoners] in Iraq. Remember the people at Stanford in the famous experiment? [He's referring to Zimbardo's famous Stanford Prison Experiment] They started abusing the prisoners almost immediately – and they weren't even really guards!

Book Recommendations

You can't predict when earthquakes will occur, but you can predict the distribution of their size, which follows what's called a power law. It's sort of like gravity – a very useful idea. A lot of think type of thinking is in Deep Simplicity [by John Gribbon. It's not published yet in North America, but here is a link to the book on Amazon.com's UK web site; they'll ship to the U.S.] Not everyone will like Deep Simplicity. It's pretty hard to understand everything, but if you can't understand it, you can always give it to a more intelligent friend. [Laughter]

I want to thank Peter Bevelin [author of Seeking Wisdom: From Darwin to Munger, which is only available at Hudson Booksellers in Omaha at (402) 345-8676 or jamhross@aol.com], who keeps sending me books. They're so good that I send them to all of my friends, which gets expensive, so I can't afford too many friends like Peter Bevelin.

I loved Caro's book – I thought it was very well done. [I assume he's referring to the first book, The Path to Power (The Years of Lyndon Johnson, Volume 1). Caro wrote second and third books: Means of Ascent (The Years of Lyndon Johnson, Volume 2) and Master of the Senate : The Years of LBJ, Vol. III.] I think reading his biography on LBJ is very important for anyone who wants a view into the human condition. LBJ never told the truth when a lie would be better. This is the way he went through life. He had a high intellect and extraordinary energy and did a lot of good along with the bad. I'm not sure he didn't do more good than bad. But I think it's an appalling life to lie as much as LBJ. What I said at Berkshire meeting about the robber barons applies here: "When he's talking, he's lying, and when he's quiet, he's stealing." [Laughter]

The Isaacson book on Franklin was terrific [Benjamin Franklin: An American Life]. He had a terrific subject – it's hard to write a bad book on such an interesting subject.

[At the Berkshire meeting, Munger also said: If you want to read one book, read the autobiography of Les Schwab [Les Schwab Pride in Performance: Keep It Going]. He ran tire shops in the Midwest and made a fortune by being shrewd in a tough business by having good systems…He made hundreds of millions selling tires.]

WESCO FINANCIAL CORPORATION

Annual Report 2004

Form 10-K Annual Report 2004

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated net ''operating'' income (i.e., before realized investment gains shown in the table below) for the calendar year 2004 increased to $47,427,000 ($6.66 per share) from $39,958,000 ($5.61 per share) in the previous year.

Consolidated net income decreased to $47,427,000 ($6.66 per share) from $74,711,000 ($10.49 per share) in the previous year.

Wesco has four major subsidiaries: (1) Wesco-Financial Insurance Company (''Wes-FIC''), headquartered in Omaha and engaged principally in the reinsurance business, (2) The Kansas Bankers Surety Company (''Kansas Bankers''), owned by Wes-FIC and specializing in insurance products tailored to midwestern banks, (3) CORT Business Services Corporation (''CORT''), headquartered in Fairfax, Virginia and engaged principally in the furniture rental business, and (4) Precision Steel Warehouse, Inc. (''Precision Steel''), headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended			
	December 31, 2004		December 31, 2003	
	Amount	Per Wesco Share[2]	Amount	Per Wesco Share[2]
Operating earnings:				
Wesco-Financial and Kansas Bankers insurance businesses —				
Underwriting	$14,618	$2.05	$15,711	$ 2.21
Investment income	26,302	3.69	30,925	4.34
CORT furniture rental business	5,022	.71	(6,257)	(.88)
Precision Steel businesses	1,094	.15	(860)	(.12)
All other ''normal'' net operating earnings[3]	391	.06	439	.06
	47,427	6.66	39,958	5.61
Realized investment gains	—	—	34,753	4.88
Wesco consolidated net income	$47,427	$6.66	$74,711	$10.49

(1) All figures are net of income taxes.

(2) Per-share data are based on 7,119,807 shares outstanding. Wesco has had no dilutive capital stock equivalents.

(3) Represents income from ownership of the Wesco headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the insurance subsidiaries, less interest and other corporate expenses.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The foregoing supplementary breakdown is furnished because it is considered useful to shareholders. The total consolidated net income shown above is, of course, identical to the total in our audited financial statements.

Insurance Businesses

Consolidated operating earnings from insurance businesses represent the combination of the results of their insurance underwriting with their investment income. Following is a summary of these figures as they pertain to all insurance operations (in 000s).

	Year Ended December 31,	
	2004	2003
Premiums written	$45,042	$ 86,962
Premiums earned	$54,589	$106,651
Underwriting gain	$22,490	$ 24,171
Dividend and interest income	36,035	44,118
Income before income taxes	58,525	68,289
Income taxes	17,605	21,653
Total operating income — insurance businesses	$40,920	$ 46,636

Following is a breakdown of premiums written (in 000s):

	2004	2003
Wes-FIC —		
Aviation pools	$26,655	$ 36,652
Property-casualty pool	(2,342)	30,390
Other	—	70
Kansas Bankers	20,729	19,850
Premiums written	$45,042	$ 86,962

Following is a breakdown of premiums earned (in 000s):

	2004	2003
Wes-FIC —		
Aviation pools	$27,944	$ 44,316
Property-casualty pool	6,244	42,021
Other	29	119
Kansas Bankers	20,372	20,195
Premiums earned	$54,589	$106,651

Following is a breakdown of after-tax results (in 000s):

	2004	2003
Underwriting gain —		
Wes-FIC	$11,144	$ 11,158
Kansas Bankers	3,474	4,553
	14,618	15,711
Net investment income —		
Wes-FIC	24,567	28,998
Kansas Bankers	1,735	1,927
	26,302	30,925
Total operating income — insurance businesses	$40,920	$ 46,636

As shown above, operating income includes significant net investment income, representing dividends and interest earned from marketable securities. However, operating income excludes investment gains of $34.8 million, net of income taxes, realized in 2003. No investment gains or losses were realized in 2004. The discussion below will concentrate on insurance underwriting, not on the results from investments.

Wes-FIC engages in the reinsurance business, occasionally insuring against loss from rare but horrendous ''super-catastrophes.'' In much reinsurance sold by us, other Berkshire subsidiaries have sold several times as much reinsurance to the same customers on the same terms. In certain instances but not always, such subsidiaries

have taken from us a 3%-of-premiums ceding commission on premium volume passed through them to Wes-FIC. Excepting this ceding commission, Wes-FIC has had virtually no insurance-acquisition or insurance administration costs. In some cases, other Berkshire subsidiaries act as reinsurers at higher levels than the level at which Wes-FIC is reinsuring; terms of the reinsurance are considered by Wes-FIC to be fair or advantageous to Wes-FIC.

For the past several years Wes-FIC's reinsurance activity has consisted of the participation in two arrangements:

(1) Participation in four risk pools managed by an insurance subsidiary of Berkshire Hathaway, our 80%-owning parent, covering hull, liability, workers' compensation and satellite exposures relating to the aviation industry as follows: with respect to 2001, to the extent of 3% for each pool, with satellite exposures effective June 1; for 2002, 13% of the hull and liability pools, increasing to 15.5% in August, and 3% of the workers' compensation pool (satellite exposures were not renewed in June); and, for 2003 and 2004, 10% of the hull and liability pools only. The Berkshire subsidiary provides a portion of the upper-level reinsurance protection to these aviation risk pools, and therefore to Wes-FIC, on terms that could result in the Berkshire subsidiary having a different interest from that of Wes-FIC under certain conditions, e.g., in settling a large loss.

(2) A multi-year contract entered into in 2000 through another Berkshire insurance subsidiary, as intermediary without profit, covering certain multi-line property and casualty risks of a large, unaffiliated insurer. This contract was commuted (terminated) in the fourth quarter of 2004, at which time Wes-FIC paid the ceding company $43.1 million, cash, representing all unearned premiums, reduced by unamortized costs and expenses. After the commutation, Wes-FIC's obligation to indemnify any further insurance losses under the contract ceased. Under that contract, there was a net reduction in written premiums of $2.3 million for 2004, compared with written premiums of $30.4 million for 2003; earned premiums were $6.4 million for 2004 and $42.0 million for 2003.

Underwriting results of Wes-FIC in both 2004 and 2003 were weirdly favorable, causing the underwriting gains of $14.6 million for 2004 and $15.7 million for 2003. Such weirdly favorable results are not to be expected over the long term. It should be recalled that Wes-FIC reported an underwriting loss of $8.1 million as recently as 2001. However, we do try to create some underwriting gain as results are averaged out over many years.

Kansas Bankers was purchased by Wes-FIC in 1996 for approximately $80 million in cash. Its tangible net worth now exceeds its acquisition price, and it has been a very satisfactory acquisition, reflecting the sound management of President Don Towle and his team.

Kansas Bankers was chartered in 1909 to underwrite deposit insurance for Kansas banks. Its offices are in Topeka, Kansas. Over the years its service has continued to adapt to the changing needs of the banking industry. Today its customer base, consisting mostly of small and medium-sized community banks, is spread throughout 30 mainly midwestern states. In addition to bank deposit guaranty bonds which insure deposits in excess of FDIC coverage, KBS offers directors and

officers indemnity policies, bank employment practices policies, bank insurance agents professional errors and omissions indemnity policies and Internet banking catastrophe theft insurance.

KBS increased the volume of business retained effective in 1998. It had previously ceded almost half of its premium volume to reinsurers. Now it reinsures only about 14%. The increased volume of business retained comes, of course, with increased irregularity in the income stream.

The combined ratio of an insurance company represents the percentage that its underwriting losses and expenses bear to its premium revenues. KBS's combined ratio has been much better than average for insurers, at 74.9% for 2004 and 65.0% for 2003. We continue to expect volatile but favorable long-term effects from increased insurance retained.

CORT Business Services Corporation (''CORT'')

In February 2000, Wesco purchased CORT Business Services Corporation (''CORT'') for $386 million in cash.

CORT is a very long established company that is the country's leader in rentals of furniture that lessees have no intention of buying. In the trade, people call CORT's activity ''rent-to-rent'' to distinguish it from ''lease-to-purchase'' businesses that are, in essence, installment sellers of furniture.

However, just as Hertz, as a rent-to-rent auto lessor in short-term arrangements, must be skilled in selling used cars, CORT must be and is skilled in selling used furniture.

CORT's revenues totaled $354 million for calendar 2004, versus $360 million for calendar 2003. Of these amounts, furniture rental revenues were $275 million and $276 million, furniture sales revenues were $68 million each year, and apartment locator fees of Relocation Central Corporation, a business CORT started up in 2001, were $11 million and $16 million. CORT operated at an after-tax profit of $5.0 million for 2004; its operations resulted in an after-tax loss of $6.3 million for 2003; it contributed $2.4 million and $13.1 million to Wesco's consolidated operating income for 2002 and 2001. Recent results have been significantly worse than CORT's $29 million of after-tax operating profits for the ten months that we owned it in 2000. The figures are before (1) goodwill amortization of $6.0 million for 2001 and $5.1 million for 2000 (see discussion below), and (2) realized securities losses of $.7 million in 2000, but include Relocation Central's after-tax losses of $7.4 million for 2004, $9.0 million for 2003, $8.3 million for 2002 and $7.0 million for 2001. Excluding the operating losses of Relocation Central, CORT, at the parent company level, contributed $12.4 million to Wesco's consolidated after-tax operating earnings for 2004, versus $2.7 million for 2003 and $10.7 million for 2002.

When we purchased CORT early in 2000, its furniture rental business was rapidly growing, reflecting the strong U.S. economy, phenomenal business expansion and explosive growth of IPOs and the high-tech sector.

Beginning late in 2000, however, new business coming into CORT began to decline. With the burst of the dot-com bubble, the events of September 11, and a protracted slowdown in new business formation, CORT's operations have been hammered, reflecting generally bad results in the ''rent-to-rent'' segment of the

furniture rental business. Obviously, when we purchased CORT we were poor predictors of near-term industry-wide prospects of the ''rent-to- rent'' sector of the furniture business. It now appears that CORT's business has begun to rebound. Furniture rental revenues for the fourth quarter of 2004 exceeded those for the comparable quarter of 2003 by 13%, and, during the year the number of furniture leases outstanding grew by 2%.

CORT started up a new subsidiary during 2001, Relocation Central Corporation, which provides the nation's largest apartment locator service through its websites, (www.relocationcentral.com and www.myrelocationcentral.com), customer call centers and walk-in locations. This start-up venture did not progress as rapidly as CORT expected and caused losses followed by some downsizing. More than 350 apartment communities now refer their tenants to CORT. Relocation Central was reorganized to become a division of CORT as of yearend 2004; it now relies more on Internet traffic and less on separate, fully-staffed facilities than previously. The integration of Relocation Central into CORT was begun in 2003 as part of a program to reduce CORT's costs and thus enhance its operating results. CORT still likes the idea of having relocation services in its product mix.

We expect to report in due course that CORT's operations have become more satisfactory. Even through the crash, CORT has operated at a positive cash flow, and the general distress in its field has permitted various small expansions. During the past four years it invested $74 million in business expansion through acquisitions of several small businesses and reduced its line-of-credit and other debt by $33 million. CORT remains the national leader in its market segment and we believe that these acquisitions will prove to be satisfactory expansions of a fundamentally sound business.

When Wesco paid $386 million for CORT, about 60% of the purchase price was attributable to goodwill, an intangible balance sheet asset.

Wesco's consolidated balance sheet now contains about $267 million in goodwill (including $27 million from Wesco's 1996 purchase of KBS). The Financial Accounting Standards Board adopted a rule which became effective in 2002 that no longer requires automatic amortization of acquired goodwill. (The requirement for such amortization has been replaced by a standard that requires an annual assessment to determine whether the value of goodwill has been impaired, in which event the intangible would be written down or written off, as appropriate.) Earnings we have reported since 2002 more closely reflect microeconomic reality as we appraise it.

CORT has long been headed by Paul Arnold, age 58, who is a star executive as is convincingly demonstrated by his long record as CEO of CORT. We are absolutely delighted to have Paul and CORT within Wesco. We continue to expect a considerable expansion of CORT's business and earnings at some future time.

Precision Steel Warehouse, Inc. (''Precision Steel'')

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, operated at an after-tax profit of $1.1 million in 2004, versus an after-tax loss of $.9 million in 2003. The 2004 figure reflects an after-tax LIFO inventory accounting adjustment decreasing after-tax income by $1.8 million. In 2003 the LIFO adjustment was insignificant. Precision Steel's operating results for 2004 and 2003 also reflect expenses of $.1 million and

$.7 million, after taxes, in connection with environmental cleanup of an industrial park where a Precision Steel subsidiary has operated alongside approximately 15 other manufacturers for many years. Had it not been for the LIFO accounting adjustment or the environmental matter, Precision Steel would have reported operating income of $3.0 million, after taxes, for 2004, versus an operating loss of $.2 million, after taxes, for 2003.

Prior to 2004, Precision Steel suffered from a significant reduction in demand for steel combined with intensified competition for quite some time. Some of the sales reduction was caused by customers' (or former customers') unsuccessful competition with manufacturers outside the United States. Although the 2004 figures appear to signal improvement, the severity of the domestic downturn is demonstrated by the fact that Precision Steel's average annual steel service revenues for the years 2001 through 2003 were down 27% from those reported for 1998 through 2000. Even after improved 2004 results, Precision Steel has not reported satisfactory operating results in recent years. Its approximately-break-even after-tax operations for the most recent four years compare unfavorably with operating profits which averaged $2.3 million, after taxes, for the years 1998 through 2000.

Precision Steel endured a difficult and chaotic year in 2004. At the beginning of 2004, a shortage of raw materials from domestic mills produced near chaos in the domestic steel service industry. Prices of those raw materials were sharply increased and the price of finished steel also increased sharply. Fortunately, the impact to date on Precision Steel has been favorable. Its 2004 revenues increased 31.2%, from those of 2003; pounds of steel products sold increased 14.5%. At present, domestic steel mills have been operating at capacity and imported steel has not been readily available. These and other factors have enabled steel mills to raise prices, place limits on order quantities and extend delivery times. Precision Steel has reacted to these pressures by passing the price increases, plus normal mark-ups, on to customers, and favoring long-term customer relationships. However, we are concerned that the favorable 2004 operating results may have been anomalous and temporary and that the steel warehouse business may revert to difficult times.

Terry Piper, who became Precision Steel's President and Chief Executive Officer late in 1999, has done an outstanding job in leading Precision Steel through very difficult years.

Tag Ends from Savings and Loan Days

All that now remains outside Wes-FIC but within Wesco as a consequence of Wesco's former involvement with Mutual Savings, Wesco's long-held savings and loan subsidiary, is a small real estate subsidiary, MS Property Company, that holds tag ends of appreciated real estate assets with a net book value of about $8.6 million, consisting mainly of the nine-story commercial office building in downtown Pasadena, where Wesco is headquartered. MS Property Company's results of operations, immaterial versus Wesco's present size, are included in the breakdown of earnings on page 1 within ''other operating earnings.''

Other Operating Earnings

Other operating earnings, net of interest paid and general corporate expenses, amounted to $.4 million in 2004, unchanged from the $.4 million earned in 2003. Sources were (1) rents ($3.4 million gross in 2004) from Wesco's Pasadena office property (leased almost entirely to outsiders, including Citibank as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiaries, less (3) general corporate expenses plus minor expenses involving tag-end real estate.

Consolidated Balance Sheet and Related Discussion

Wesco carries its investments at market value, with unrealized appreciation, after income tax effect, included as a separate component of shareholders' equity, and related taxes included in income taxes payable, in its consolidated balance sheet. As indicated in the accompanying financial statements, Wesco's net worth, as accountants compute it under their conventions, increased to $2.12 billion ($297 per Wesco share) at yearend 2004 from $2.08 billion ($292 per Wesco share) at yearend 2003. The main cause of increase was net income after deduction of dividends paid to shareholders.

The foregoing $297-per-share book value approximates liquidation value assuming that all Wesco's non-security assets would liquidate, after taxes, at book value.

Of course, so long as Wesco does not liquidate, and does not sell any appreciated securities, it has, in effect, an interest-free ''loan'' from the government equal to its deferred income taxes on the unrealized gains, subtracted in determining its net worth. This interest-free ''loan'' from the government is at this moment working for Wesco shareholders and amounted to about $32 per Wesco share at yearend 2004.

However, some day, parts of the interest-free ''loan'' may be removed as securities are sold. Therefore, Wesco's shareholders have no perpetual advantage creating value for them of $32 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than $32 per Wesco share.

Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway. Moreover, the quality disparity in book value's intrinsic merits has, in recent years, continued to widen in favor of Berkshire Hathaway.

All that said, we make no attempt to appraise relative attractiveness for investment of Wesco versus Berkshire Hathaway stock at present stock-market quotations.

To progress from this point at a satisfactory rate, Wesco plainly needs more favorable investment opportunities, recognizable as such by its management, preferably in whole companies, but, alternatively, in marketable securities to be purchased by Wesco's insurance subsidiaries. Our views regarding the general prospects for investment in common stocks are unchanged two years after Warren Buffett wrote the following, in his 2002 annual report to shareholders of our parent company:

> ''We continue to do little in equities. [We] are increasingly comfortable with our holdings in [our] major investees because most of them have increased their earnings while their valuations have decreased. But we are not

inclined to add to them. Though these enterprises have good prospects, we don't yet believe their shares are undervalued.

"In our view, the same conclusion fits stocks generally. Despite three years of falling prices, which have significantly improved the attractiveness of common stocks, we still find *very* few that even mildly interest us. That dismal fact is testimony to the insanity of valuations reached during The Great Bubble. Unfortunately, the hangover may prove to be proportional to the binge.

"The aversion to equities that [we] exhibit today is far from congenital. We love owning common stocks — if they can be purchased at attractive prices. In [my] 61 years of investing, 50 or so years have offered that kind of opportunity. There will be years like that again. Unless, however, we see a very high probability of at least 10% pre-tax returns (which translates to 6½-7% after corporate tax), we will sit on the sidelines. With short-term money returning less than 1% after-tax, sitting it out is no fun. But occasionally successful investing requires inactivity."

In fact, the one thing that should interest Wesco shareholders most with respect to 2004 is that, as in 2003, 2002 and 2001, Wesco found *no* new common stocks for our insurance companies to buy.

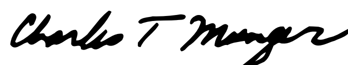
Shareholders should note that the recently announced sale of The Gillette Company to The Procter and Gamble Company, subject to shareholder approval later in 2005, is expected to result in Wesco's recognition of an investment gain of about $190 million, after income taxes. No income taxes will be paid in cash, and all of Wesco's Gillette shares will be converted into Procter and Gamble shares. Although we will be pleased to become owners of shares of Procter and Gamble, we do not regard this "mere accounting" gain as significant to Wesco shareholders.

The Board of Directors recently increased Wesco's regular dividend from 34½ cents per share to 35½ cents per share, payable March 2, 2005, to shareholders of record as of the close of business on February 2, 2005.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Shareholders can access much Wesco information, including printed annual reports, earnings releases, SEC filings, and the websites of Wesco's subsidiaries and parent, Berkshire Hathaway, from Wesco's website: www.wescofinancial.com.

We regret the pending retirement of Wesco's President, Bob Bird, who is not standing for reelection. He has been, in effect, my partner for over 35 years and has never failed in giving wise and diligent service.



Charles T. Munger
Chairman of the Board

March 9, 2005

Notes from 2005 Wesco Financial Annual Meeting

May 4, 2005

By Whitney Tilson

Note: This is not a transcript. No recording devices were allowed at the meeting, so this is based on many hours of rapid typing, combined with my memory. I have reorganized comments by subject matter. Words in [brackets] are my comments or edits.

For my columns and notes on previous Berkshire and Wesco meetings, click here.

CHARLIE MUNGER'S OPENING REMARKS

I feel a duty in these later years to talk a little bit because so many of you have come so far and therefore I'm going to talk a little about current change conditions in corporate governance, the investment world, how we're adapting at Berkshire Hathaway and Wesco, and how you might face these challenges.

Corporate Governance

First, corporate governance. We're having a mild revolution in corporate governance. Congress passed rules requiring that a majority of directors be independent, which has affected all kinds of companies, including Berkshire Hathaway and Wesco. At Costco, we added Bill Gates Sr. [actually, Bill Gates's father is Jr. and Bill Gates, the head of Microsoft, is Bill Gates III (hence the nickname "Trey"), but everyone calls them Sr. and Jr.] and Daniel Evans – I like to see young people joining the board. [Laughter. Gates and Evans are both 79 years old.]

I think it's a plus at Berkshire Hathaway. We have a very able, brilliant group of shareholders. We pay a pittance but everyone we asked [to join our board] agreed to come aboard: Bill Gates, Sandy Gottesman, Tom Murphy, Don Keough, Charlotte Guyman – there's a couple of billion dollars of Berkshire Hathaway stock in the Gottesman family.

Sarbanes-Oxley

Then they passed Sarbanes-Oxley, which creates all kinds of oaths and compliance procedures. One thing it caused was an enormous increase in costs. The auditors must certify the internal controls. At Berkshire Hathaway, including Wesco, this used to cost $200,000 but now it's in the multiple millions. It's not all wasted though – only about 80% is wasted. (Laughter)

There are some results to the good. But the cost of being a publicly traded stock has gone way, way up. It doesn't make sense for a little company to be public anymore. A lot of little companies are going private to be rid of these burdensome requirements.

The problem is that you can require people to solemnly swear that their financials are accurate, but the only way to do it is to trust a lot of other people. That's what they did before and that's what they do now. I think someone in Congress thought that the President of Exxon would run around and count the barrels of oil. Well, it's not going to happen. There needs to be deserved trust.

I think the current requirements are good. It makes it easier to prosecute crooks. But for the organization and for ordinary people, I don't think Sarbanes-Oxley will create a lot of control.

Impact of Scandals and Press Coverage

But another change is having a dramatic effect on corporate governance and behavior – that's the widespread scandal and press coverage which has caused shame, disgrace, personal legal costs, and ruined many lives. *That* has changed behavior – even more so than in the past, during the price-fixing scandal when they carted executives off to jail. That had an effect [but the current scandals are having more of an effect].

This wave of scandal and widespread press coverage has had an unbelievably strong impact on corporation behavior – it's overdue.

Think of the publicity of Enron, WorldCom and Tyco. And the mutual fund industry – many firms had some whiff of scandal. Personally, I think what happened to the Strong funds was an outrage. The independent directors found him stealing, but instead of firing him and finding another manager for the funds, they instead allowed him to sell the firm. This shows how permissive and evil a culture can become.

Kudos to Spitzer

Prosecutors have used the press instead of relying on quiet lawyerly procedures. Personally, I'm in favor of this approach. While some have claimed that this is abusive, 99% of the time it's not.

As far I'm concerned Eliot Spitzer has behaved very well and has done a lot of good. He's caused a lot of reforms the SEC wouldn't have caused.

Some claim that those targeted by Spitzer are not getting due process, but only lawyers like endless due process – they get paid by the hour. It reminds me of the story about the lawyer who goes to hell and all he gets is endless due process and no decision.

There's been a tremendous change in behavior. In the insurance business, I'd say it's changed virtually overnight. All kinds of gamey insurance products which fall under financial reinsurance – a meaningless term, by the way – you couldn't get written today.

Obsession With Quarterly Earnings

In many corporations, there's an obsession with meeting quarterly earnings targets. To do so, they'd fudge a little, sell stock at a capital gain, sell a building or two... Then, if that wasn't enough, they'd engage in channel stuffing – if you were selling through a middleman, you could unload your product at the end of the quarter and make the current quarter look better, but of course the next quarter would be worse. It went on a lot and the penalties were pretty light. For many major pharmaceutical, consumer products and software companies, at the end of quarter, this was very common. That's pretty well over. A few public hangings will really change behavior.

One of our Presidents said if he could execute three people each year for no cause, it would make it a lot easier to govern. When someone said that's not enough, he said, "Oh yes it is, because I'd publish the list of people under consideration." (Laughter)

So this is all to the good and the cost of doing it has been really low. The public hanging aspect has really worked. People now go to seminars to learn how to avoid this.

Sentencing shows that if you try to avoid this [companies trying to avoid reporting false or misleading earnings], you'll get lower penalties, so corporations are putting in policies to prevent this.

Temptation of Commissions

This has worked in the insurance and reinsurance industries. It has worked less well where you have direct commissions because you have a sales force relying on commissions. You'll always have brokers, annuity salesman and the like who go astray. You'll never be able to stamp it out in these areas. It's human nature – people will rationalize all sorts of things to get paid.

If you want good behavior, don't pay on a commission basis. Our judges aren't paid so much a case. We keep them pretty well isolated with a fixed salary. Judges in this whole thing have come out pretty well – there have been relatively few scandals.

So not everything has gone to hell in a bucket in our civilization. (Laugher)

Accounting Firms and Investment Banks

Accounting firms and investment banks had reached a near bottom. The combination helped messes like Enron to happen.

In the accounting business, you've had a change – it's been separated from the consulting business.

There's another temptation: building buildings. You can save a lot of money by pouring less concrete, which is why buildings in Latin America often fall down. People will yield to temptation if they're not carefully checked, so we have regulations and the building commissioners actually have to be present when the concrete is poured. By and large, [the result is that] the building record is pretty good in the U.S.

Building inspectors and permitters are like judges – they are paid a salary.

In accounting, we're not going to treat them like building permit issuers – limit them to just checking things. We let them do consulting for tax shelters, etc. I was for it all the way along because for the most part they could do these things and the behavior was pretty good. But four or five years ago, this changed and pretty much every major accounting firm was selling fraudulent tax shelters and were participating – at least one partner was – in accounting fraud. They have thrown out those partners, in some cases reluctantly, but in any case they're gone and the accounting is way better.

Whether we should have gone all the way and only let accounting firms do audits is an interesting question. I like accounting firms – we've had good service. But given all the temptations, I don't know if it wouldn't be best to make them do only audits.

If we have another wave of scandals, CPAs will be asked to choose between certifying the accounts of publicly traded corporations vs. other activities. They hate it – checking the accounts is very boring; other work is more interesting, so they won't be able to attract good people [to the profession].

The investment banks were just unbelievable. If you want to be really horrified, those of you who haven't already read FIASCO [The Inside Story of a Wall Street Trader, by Frank Partnoy], the account of the derivatives trading desk at Morgan Stanley, it will turn your stomach.

I recommend the new book by Kurt Eichenwald, Conspiracy of Fools [about the Enron scandal]. He takes some liberties, like what the guy was thinking as he got on the elevator, but I don't think the gist is wrong. The title is right: Conspiracy of Fools. A lot of this was delusion.

But the thing that is sickening is the investment bankers – but lawyers and accountants behave badly too.

It's good to rub your nose in it. If you can't stand it all at once, then do it in bursts. If you throw up in between episodes, that's OK too. (Laughter)

Some of these faults ought to be judged as they are in the church – as mortal vs. venial. The sin of smoothing of earnings was so widely done by so many people that we have to

accept it as a venial sin. But now we're changing the category, and we should. I think we should think long and hard before we smooth the achievement record.

I think a lot of smart people have decided "I'm not going within 10 miles of this whirlpool that can suck you down, break you up and spit you out." Some people who only had small sins are going to get clobbered. But overall the prosecutorial discretion has not been abused.

However, once people are disgraced, pay a fine, etc., what's the point of beating up a guy who's half dead? Once he's disgraced, do you need to stomp on him?

I don't want to suggest that all of the puffery and folly is over, however.

Now they wear tailored suits, but there's a good bit of the old Mark Twain culture in those suits.

Part of it is from people who shrink from doing unpleasant things. Who hasn't? It's terribly unpleasant to fire someone. Or how do you tell someone not to go into a field [of business] with lots of money to be made because it smells? Or if their incomes are going down, there's huge pressure to invent some products to keep their income up.

That's why Warren doesn't lay people off when our home-grown insurance company volume goes down.

There's been ghastly behavior in the sale of annuities. The idea of shifting an old lady from one annuity to another to make a commission – you laugh, but it happens. The trouble is always with us.

At the cost of being sickened by all the scandal, I think the behavior is getting better.

Hedge Funds

I don't know what will happen with hedge funds. They now have $1 trillion and all of them are on margin. History would indicate a certain percentage will lie about their results if they have any discretion whatsoever, and will try to cover up market errors if they can. I can confidently predict scandals. It will always be thus.

Corporate Compensation

The corporate governance thing, as it affects compensation, I do not think is getting improved. They [CEOs] will accomplish the same old thing, helped by clever lawyers. People will just get more sophisticated in the way they do it.

Perhaps a semi-public place like the NYSE will behave better, but the ordinary corporation will continue to escalate compensation. The key officers appoint the directors and then the directors decide how much the officers make. And then the

officers increase the compensation of the directors, etc. You look around the table and nobody else is objecting. There are psychological pressures tending to gross abuse. That's not to say that all CEOs are overpaid. In my opinion, Jack Welch was *under*paid for what he did at GE.

But if you rise high in a corporation or elsewhere in life, you have a duty to be an exemplar – you have a duty to take less than you deserve, to set an example. This goes all the way back to Athens. The Athenians were like today's United Jewish Appeal. Public duty was not optional. Civilized man had a duty to act as an exemplar – and this was not a minor duty; it was a major duty of life. This is not mentioned by compensation consultants. (Laughter)

Conduct Unbecoming an Officer

This should change. When I was an officer in the military, we had a rule called Conduct Unbecoming an Officer. It was not specific, but it said there were certain ways to behave as an example for others. I don't see why we shouldn't have this for our corporate executives. I would argue the CEO of Boeing was removed for Conduct Unbecoming an Officer. Messing up the email system of a corporation with hot and dirty email is Conduct Unbecoming an Officer. I would *love* to see the SEC make it explicit: "We hereby exercise our authority and say that there will be a new standard for officers of public companies called Conduct Unbecoming an Officer." The lawyers would scream though – it's not specific enough.

But if we ask our military officers, who risk their lives and risk being maimed [to adhere to this standard], then why can't we ask this of some guy making $2 million per year? (Applause)

Well that's corporate governance. It's certainly been interesting to watch as these messy stories unfurl.

More on Bad Accounting

Oh, I'd say this: if you read the Eichenwald book on Enron, if there's one issue to highlight, it's that Arthur Andersen and the SEC allowed them to use Wall Street accounting to account for long-term contracts. It's one of the worst things. A well-trained orangutan could see what it would lead to, but the SEC and the accountants lay down. This was 90% of the problem.

When accountants lie down, they are failing civilization in a truly important way. There's no reason that people so secure – there are only four firms and they're all the same, so it doesn't do any good to fire them – can't do better than they do. They're secure and it's terrible publicity, so there's no reason the accounting can't be better.

Investment returns

There's $1 trillion in hedge funds and private equity is 3-4 times larger. Private universities have fixed-income departments, private equity for mid-stage investments, masses of complicated math to track risk in each class and how to judge each class, etc.

So far, it's worked beautifully for Harvard and Yale – they got into some good things. But I feel about Harvard and Yale the way I feel about my own career: I feel that by getting rich in the way I did, I think my own example has hurt my own country. I think that Harvard and Yale have caused every charitable foundation to act in the same way. I think it has pernicious effects on civilization.

Too Much Brainpower Going Into Money Management

It's my guess that something like 5% of GDP goes to money management and its attendant friction. I define it broadly – annuities, incentive pay, all trading, etc. Nobody else has used figures that high, but that's my guess. Worst of all, the people doing this are among the best and the brightest. Hundreds and thousands of engineers, etc. are going into hedge funds and investment banking. That is *not* an intelligent allocation of the brainpower of the civilization.

While we're doing this, in Korea at Samsung, they have a meeting every day at 11 pm to review the day. Well, who is going to win if our brainpower is going into hedge funds and theirs is having a meeting at 11 pm? But nobody is talking about this. These people are honored. If people talk at the country club, one person might say, "Boy, my daughter is getting married to a hedge fund manager." They're making heroes.

My daughter is an art dealer and she says that most of her business is selling to hedge fund managers. If you make $100 million, why not have a fancy apartment and two Chagalls? You can't get this [kind of money] elsewhere, so it goes on.

Too Much Credit

The action, the trading, the amount of credit... And to get good returns, the hedge funds need more use of credit.

Of course, the firms that are extending the credit are the investment banks. If there's any great wave of running for the exits, those people will get out fast. Unless the Federal Reserve decides to protect hedge funds, you could have a real mess.

Tough Environment

So that's where we're at. Meanwhile, it's like an Easter egg hunt with too many hunters and not enough eggs. So you value investors, look around the room. There are a lot of hunters. So if you're having trouble, please join the club.

I regard that as a very interesting development. I don't think I've ever seen in my whole life – it's hit all asset classes together. Real estate is priced very high by past standards. Stocks are priced very high by past standards. Fixed income is priced very high by past standards. All of these asset classes have been hit. And all of these people accounting for a vast part of GDP want to get rich, and they will likely push.

This could end up in two ways: keep going up or there could be a classic bust, as occurred in Japan.

The competition to buy companies is heating up. The private equity firms will rationalize almost any price. My friend buys warehouses and for months he's been unable to buy anything. He says, "All I do is raise the price paid to the owner of the warehouse." So my friend stopped trying to buy warehouses.

The Rise of the Orient

Take the vast improvement of conditions in the Orient – that is really something. At Berkshire Hathaway we do *not* like to compete against Chinese manufacturers. They learn fast and are good at getting things to you. They're coming up fast.

The amount of talent in the Asian populations is amazing. They were held down by ridiculous systems -- first ruled by autocrats and then by communists – but now under capitalism, the potential is awesome.

My test is I look at symphony orchestras. For the hardest instruments, that require the most dedicated training, 80% of the faces are Asian. This was not true years ago. They are a very talented, driven ethnic group. A good thing about the U.S. is that they come here. Look around this room – look how many Asians are here. 20 years ago at the Wesco meeting, this was not true.

Go to the UC Berkeley engineering department – you'd think you were in Asia.

My grandchildren may be displaced [by Asians]. If so, that's too damn bad for the Mungers. I'm all for meritocracy.

The economic implications are huge when you have a population base so large, so intrinsically talented, with family values so good. I don't know an Asian family that doesn't kill itself for education. In Korea, one of the biggest businesses is tutors. Kids go to school all day and then the tutor comes – and the kid is three! (Laughter)

We're getting a taste of meritocracy. It does not mean you can just go invest in China, however. The first movers can get killed. There's a saying in Indonesia: "What you're calling corrupt is Asian family values." (Laughter)

Future Outlook

There may be implications for the rest of you. Something weirdly bad can happen, so prepare for it. Or we could be in for a period with no calamity, but lousy returns. There have been long periods when this was the case – most recently, the 15 years ending in 1981. But now everyone is conditioned to expect high returns. Read the committee reports from Harvard and Yale – they see no reason not to do better than average. After all, they have done so historically.

I think size will hurt returns. Look at Berkshire Hathaway – the last five things Warren has done have generated returns that are splendid by historical standards, but now give him $100 billion in assets and measure outcomes across all of it, it doesn't look so good.

We can only buy big positions, and the only time we can get big positions is during a horrible period of decline or stasis. That really doesn't happen very often. You people are lucky to not have a lot of money. We have a lot of money and we'll endure. (Laugher)

Well, that's the investment climate.

CHARLIE MUNGER RESPONSES DURING Q&A SESSION

Berkshire Operates With a Seamless Web of Deserved Trust

Everybody likes being appreciated and treated fairly, and dominant personalities who are capable of running a business like being trusted. A kid trusted with the key to the computer room said, "It's wonderful to be trusted."

That's how we operate Berkshire – a seamless web of deserved trust. We get rid of the craziness, of people checking to make sure it's done right. When you get a seamless web of deserved trust, you get enormous efficiencies. It's what the Japanese did to beat our brains out in manufacturing: suppliers, employers, the purchasing company, management – all created a seamless web of deserved trust. That's why we have firms – they create a seamless web of deserved trust. It's the same with good football teams.

Berkshire Hathaway is always trying to create a seamless web of deserved trust. Every once in a while, it doesn't work, not because someone's evil but because somebody drifts to inappropriate behavior and then rationalizes it. Our basic attitude is to create a seamless web of deserved trust.

How can Berkshire Hathaway work with only 15 people at headquarters? *Nobody* can operate this way. But we do.

Take Wesco. Every once in a while we get surprised by something – maybe once a decade. It's what we all want. Who in the hell would not want to be in a family without

a seamless web of deserved trust? We try for the same thing in business. It's not rocket science; it's elementary. Why more people don't do it, I don't know. Perhaps *because* it's so elementary. We didn't copy the Japanese until they were clobbering us – and they copied from us!

Lowered Investment Standards at Berkshire Hathaway

At Berkshire Hathaway, we've lowered our standards a little – we're willing to invest with lower standards than in the past. We're not waiting for 1974 or even 1984. If you have the money, you have to invest it somewhere. It may well be that you have to take something that obviously promises a lower return than you were used to.

I think the people who say "I need more" and therefore try to get more than they need, are likely to get into terrible trouble. I know a man who owned his house free and clear, had $5 million of securities and lived on the income from those securities. But this left him a little short of what he wanted, so he said to himself, "I'll go do a little work to get my return up," and he sold puts, backed by his entire account. At the time, the highest price was on naked puts on Internet stocks and in due course he lost all of his money and now works in a restaurant.

We Buy With Reduced Expectations

Warren said at the annual meeting that with most of our present holdings, we're not buying or selling. And when we do buy, it's not, "Oh boy! A lollapalooza!" We buy with reduced expectations. How else can one behave? Would anyone want us to reduce Berkshire Hathaway's assets to cash and sit around waiting for a calamity so Berkshire can put the cash to work?

By No Means Have We Given Up on Putting Our Cash to Work

Warren answered this at the [Berkshire] annual meeting. By no means have we given up on putting our cash to work. And if we don't, the money is not going away.

Did You Predict Berkshire's Success?

Well, some of our success we predicted and some of it was fortuitous. [Regardless,] like most human beings, we took a bow. (Laughter)

Common Elements of Berkshire's Best All-Time Investments

Some eventualities came to pass. What the 15 best deals all have in common is that they all worked. There were different models – See's Candies was different from Shaw Carpets. But both are good businesses that will generate durable returns for the grandchildren of people sitting in this room. The reason I keep talking about the record without the 15 best deals is that it shows how few deals you need in a lifetime. The

people who need a deal every month, by and large, they all crater. Patience and aggressive opportunism is what you need – an odd combination, but it's what works best.

Berkshire and Wesco Buying Back Stock?

Buffett answered this question [at the Berkshire annual meeting]. At some price, we'd buy back Berkshire, but it's quite a bit less than the price that currently exists. We're not looking for the chance to gleefully buy out shareholders at a substantial discount to its value. We like to behave so this doesn't happen.

As for Wesco, because you people have created this cult, it always trades at a premium to its liquidation value.

Bull on Berkshire

Despite my words, I'm a bull on Berkshire Hathaway. There may be some considerable waiting, but I think there are some good days ahead.

Stocks We're Buying

[I missed the rest of the sentence, but at one point Munger said: "…the stocks [plural] that we're buying today…"]

Problem of Buffett Foundation Having to Eventually Sell Berkshire Stock

I regard that as so easily solvable that I don't give two seconds to it. If the foundation has to sell 5% of its stock [every year to comply with the law that says all foundations must give away 5% of their assets each year], then Berkshire could pay a dividend or buy back the stock. It wouldn't bother me – we're drowning in cash. The needs of any one shareholder are easily dealt with in our current circumstances. You lead a very favored life if you worry about things like that.

COMMENTS ON BERKSHIRE HATHAWAY BUSINESSES

Advantage of Berkshire's AAA Credit Rating In Insurance

There's a little price tiering – there's a difference among insurers based on their credit worthiness. But is there enough difference? The answer is no. Do I expect a cascade of business to Berkshire Hathaway? No. But there's a modest and increasing trickle. People are not as credit-leery as they should be.

Pricing Super-Cat Insurance Policies

We're very peculiar. We don't have a department where we trust people to do it on their own. All decisions must be approved by Ajit Jain and Warren, and neither of them uses standard actuarial tables. In other words, after a long period with no hurricanes, the

actuarial tables would tell you that the hurricane risk has gone down – that's not how they think at Berkshire Hathaway. There're very rational. We don't use standard actuarial tables, just as we start with [companies'] reported financials, but then go from there.

You don't need dozens of people to write super-cat policies. So there's our plan: get Ajit Jain, add Warren Buffett working for free and then raise tens of billions of dollars because people trust you and there you go. (Laughter)

We Have Simple Compensation Systems

It isn't enough to buy the right business. You've also have to have a compensation system that's satisfactory to the people running them. At Berkshire Hathaway, we have no [single] system; we have different systems. They're very simple and we don't tend to revisit them very often. It's *amazing* how well it's worked. We wrote a one-page deal with Chuck Huggins when we bought See's and it's never been touched. We have *never* hired a compensation consultant.

Clayton Homes and the Disaster in the Manufactured Home Sector

The recent historical experience of mobile homes – actually, it's "manufactured"; they're not manufactured to move – is that you had a bunch of no-good nut cases and a balloon of unfortunate, commission-sales-driven activity. Any time you let people on sales commission set the credit standards for people using margin [e.g., debt to buy the home], you create a disaster. It's like mixing oxygen and hydrogen and lighting a match.

The homes deteriorated... It was an absolute disaster. If it hadn't been, we wouldn't have been able to buy [Clayton Homes]. [The distress in the industry was so great that] they were losing their securitization capacity. Clayton was the best, but even they were at risk so they sold to us.

What do you know about foreclosing on a house in a trailer park? And what do you do with it? We're now the largest in the country. I think it will work quite well for Berkshire and Clayton. If Clayton were an independent company, they'd have trouble. The people who claim we underpaid for it are out of their minds. It's amazing how many people think they know more than the people selling it.

Cort Will Be Successful Over Time

Cort benefited from the venture-capital-financed, new-company boom. You could argue that we made a macro mistake. These companies went away for a while and Cort was affected. But you can see in the first quarter earnings that it's coming back.

There's a class of people that just want to rent, not own. They are trying to be the Enterprise Rent-A-Car in the furniture rental business. It's not a gold mine, but we think it'll be successful over time.

INVESTMENT ADVICE

Behavior of Investment Managers

If you're an investment manager and they're going to fire you if you don't keep up with your benchmark, that can cause some weird things to happen in the markets as a whole. That's the world that we live in, whether you like it or not. It has some perverse consequences – for one thing, closet indexing. You're paying a manager a fortune and he has 85% of his assets invested parallel to the indexes. If you have such a system, you're being played for a sucker.

You have these fads in investment management. With so many bodies and minds and computers, I see figures of risk by asset class, but I don't have the faintest idea what they mean. They don't either, but they learned a fad, a way of thinking. If you learn a formula, you can run the numbers and print it up, but it doesn't mean anything.

Are Stocks Too High?

Too high is a funny word – they are high to those of us who are accustomed to finding real bargains. But it's not a promise [that there will always be such bargains]. I don't think it's unfair; I don't think it's too high in the sense that we're being deprived.

Our future prospects are way worse than what they used to be. But I'm 81; I've got bigger problems than diminished returns. (Laughter)

Spotting Bad People

It's hard to judge the combination of character and intelligence and other things. It's not at all simple, which explains why we have so many divorces. (Laughter) Think about how much people know about the person they marry, yet so many break up. It's not easy, it is in some cases. If people are splashing around with money like Dennis Kozlowski, with vodka at parties coming out of some body part, and if it looks like Sodom and Gomorrah, then maybe this isn't what you're looking for. (Laughter) But beyond that, it's hard. If you have some unfortunate experiences while getting that knowledge, well, welcome to the human race. (Laughter)

It's Tough to Make Money Investing in China

I think it's very tough to make money in China. A lot of terrible things can happen to you and you have no good antidote. China makes a lot of cheap well-made goods, but it could be that we won't have attractive investment opportunities in China even though the country may prosper.

We Want the Chinese to Get Richer

China is a nuclear power. We have no option but to have friendly relations with China – anything else would be really stupid. We *want* the Chinese to get richer and richer. I'm not unhappy that Wal-Mart is expanding in China.

Risk of a Calamity Investing in Currencies

I do think that it's conceivable that some enormously talented person that studied economics and relative value of currencies and devoted his life to it and only bet occasionally, that such a man could do very well [investing in currencies]. It's not my line of talent.

I'd rather do something that's not such a zero-sum game. If I invest in equities – the businesses are growing; for example, Wrigley's will make more gum. It's automatically working for me, even if I do nothing. But if I invest in currencies, it's not working for me.

If I had to make a living outside of equities, it might be in currencies. But I don't have to do it. There's less chance of a big calamity in equities. The problem with currencies is that it sucks you into margin, and then if it moves against you but you're sure you're right, it sucks you in deeper. And then one more twist of the screw…

If you're already rich, why would you live under such conditions? I think more people will do well if they follow the Warren Buffett model.

COMMENTS ON OTHER COMPANIES

I Think the Country Is Better Off for Having Wal-Mart

With Wal-Mart and the like getting so powerful, have we made a pact with the devil? My answer is I think the country is better off for having Wal-Mart. It's a fabulous enterprise that does a lot of good and delivers value to the customer and that's why it's successful. I think the country is better off for having this system for distributing goods.

When I go into Wal-Mart, I see elderly people as greeters – they're working part time and it gets them out of the house, but people say, "Isn't Wal-Mart nasty [for exploiting the elderly]?"

As far as I'm concerned, I think Wal-Mart does a lot of good with efficient distribution. I'm a director of Costco. Do we really want our entrepreneurs not to try very hard? Do we really want to wake and say, "Let's stop competing so hard?" I say, let winners run instead of investing in losers.

I like Wal-Mart's culture. As far as I'm concerned, Wal-Mart is one of the glories of civilization.

McDonald's Is a Great Educator

I get flack for saying [when I visit a college and give a speech], "This is a nice college, but the really great educator is McDonald's." They hate me for saying this and think I'm a slimy creature. But McDonald's hires people with bad work habits, trains them, and teaches them to come to work on time and have good work habits. I think a lot of what goes on there is better than at Harvard.

There's a Lot That Was Strong and Good at AIG

I've never examined AIG in great detail. AIG was run by a truly brilliant, dominant personality for a long, long time and had a fabulous record. I don't think we're going to find a fraud like Enron. Rather, a good company with a chieftain that maybe gilded the lily. I think he thought it was his duty to help along the reputation of AIG. I think he thought it deserved a better reputation than it had. I agree. I think every corporate chieftain feels the same way. I don't think it's blue smoke and mirrors.

I will miss Hank Greenberg dearly in areas like tort reform. He was always honest with us. He invited us or we invited him in the deal to buy the assets of Long Term Capital Management. There's a lot that was strong and good at AIG.

AIG, GE Credit and the Risks of the Carry Trade

That said, it's a lot like GE. It is a fabulously successful insurance operator, and with success it morphed into a massive carry business: borrowing a lot of money at one price and investing it at another price. AIG was a big operator that was a lot like GE Credit. We never owned either because even the best and wisest people make us nervous in great big credit operations with swollen balance sheets. It just makes me nervous, that many people borrowing so many billions.

As you can tell in our operations, we are much more conservative. We borrow less, on more favorable terms. We're happier with less leverage. They've been successful, but we're too chicken to join them. You could argue that we've been wrong, and that it's cost us a fortune, but that doesn't bother us. Missing out on some opportunity never bothers us. What's wrong with someone getting a little richer than you? It's crazy to worry about this.

There's a lot of leverage in those carry-trade games. Other people are more certain than I am that aircraft can always be leased.

I Would Never Dream of Shorting GM

I would never short a company that was doing $180 billion [in sales] per year with a market cap of $15 billion that was such an iconic part of America. I would never dream of making that short.

What happened was that a lot of very decent people running GM basically blew it. They were facing a very serious competitive challenge and they set up a [lifetime healthcare and pension] system that will grow and grow and grow and they are paying one hell of a penalty.

Employees have 5-6 times the value in their pension plan than all of the stockholders combined. [At the time, GM had a market cap slightly above $15 billion vs. approximately $90 billion set aside for pension liabilities.] GM gave all of the value of the company to employees and left shareholders with almost nothing. They didn't observe the maxim that a small leak can sink a great ship. They never should have allowed the unions to bargain with each company and shut one company down and let the other two take share. They should have bargained as a unit. The result today is a combination of what they gave away one year at a time.

I regard GM as such a marvel of human achievement, but also an example of massive management failure. I can't be criticized if I eventually die – I delayed it as long as I could. GM delayed it as long as they could. They had a very tough hand to play, but I would argue that they blew it.

I don't think Berkshire Hathaway will blow its hand in this way. It would never do that. We would do some very unpleasant things to prevent something that would have very bad consequences far into the future.

Nuclear weapons are a very serious problem. [It's so awful to contemplate that] people use gallows humor. What would you do if you were told a nuclear bomb would be detonated over Pasadena right now? The answer: you'd crawl under the table and kiss your ass goodbye. (Nervous laughter)

Comments on Leucadia and Its Investments in Telecom

We regard the Leucadia people as very smart. Is it conceivable that the Leucadia people could have one outcome that didn't work very well? Sure, it's possible.

I look at telecom and all the change and my reaction is that of Samuel Goldman: "Include me out." I'm just not suited for this; I don't know how to predict those outcomes, so I leave it to other people.

COMMENTS ON ECONOMIC MATTERS

Awash in Capital

It is weird the way that capital occurs. We have monetized houses in this country in a way that's never occurred before. Ask Joe how he bought a new Cadillac [and he'll say] from borrowing on his house. We are awash in capital.

[Being] awash is leading to very terrible behavior by credit cards and subprime lenders -- a very dirty business, luring people into a disadvantageous position. It's a new way of getting serfs, and it's a dirty business. We have financial institutions, including those with big names, extending high-cost credit to the least able people. I find a lot of it revolting. Just because it's a free market doesn't mean it's honorable.

Social Security Is Amazing

I'm not so sure that common stocks will do wonders. In England, where they tried to create a scheme like this, they let the brokers and salespeople loose on the people and it was a disaster. So they [those in the U.S. who are pushing to allow people to invest their Social Security savings themselves] said, "We won't do that. We'll just package them in index funds." But the way it's set up, it's like an arbitrage. A guy gives up the promise of Social Security to take the promise of an index fund.

Social Security is amazing how we've run it. It's inflation protected. It's easy to sneer at it, but it's one of the most successful government programs ever. It's low cost and encourages work.

People say if you never change the revenue base, it'll run out of money. But if 10 years from now, the country is 30-40% richer, why not use a higher percentage of GDP to pay people? Young people benefit too – the money is paid to people who might be moving in with them. (Laughter) Everybody's going to get older, but also richer, so why wouldn't you spend a higher percentage of GDP on them? Why is that so unthinkable? I'll tell you what's unthinkable: that so many people are that stupid! (Laughter)

Likelihood of an Energy Shortage

There's a lot of evidence of that – that our conventional techniques of extracting oil will eventually taper off, [a theory called] Hubert's Peak. [First articulated more than 50 years ago by a Shell Oil geologist, this theory describes how production rates of oil and gas will increase to a peak and then rapidly taper off as reserves are depleted.] I'm sure that will happen eventually. But you can never be sure. Some people think that energy reserves are not from deceased former life – for example, there's methane in the heavens where there was no former life. So there may be more energy than people expect…

I recall reading something about Chevron finding a lot of energy way deep, some kind of hydride – a deep reserve with a lot of energy locked up. So there may be one last gasp – one more windfall coming of hydrocarbons. If we have to live without hydrocarbons, we can, but it would just be unpleasant. An awful lot of energy comes to the earth every day from the sun. If we had to adjust, we could.

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Rick Guerin's Not Crazy – We Are

[Guerin was one of the investors Buffett profiled in his famous speech, The Superinvestors of Graham-and-Doddsville]
I think it's fair to say that once he got rich, he stopped spending his time trying to get

richer. He has a new family. He's 75 and has a 12-year-old child. He does a lot of things because he enjoys doing them. He's stopped trying to get richer. There's *nothing* crazy about that. We're the crazy ones. (Laughter)

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But a book like the one I just recommended [*Conspiracy of Fools*, by Kurt Eichenwald] – that Enron book is *really* worth reading because the evil is so extreme. You see people getting sucked in by the evil all around them. You just learn so much. You know the outcome – it's like a tragedy. Not everyone likes tragedy – I took my wife to a movie where the rats were eating the bodies of the dead soldiers in World War I. Afterward, she told me, "You may like this, but I never want to go to another one." It was *King & Country*.

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One way to find a lot of love in yourself is to surround yourself with a lot of hard-core nut cases. Yes I do. You're my kind of people – my kind of screwy.

Notes from 2005 Wesco Financial Annual Meeting, Part Two

May 4, 2005

By Whitney Tilson

Note: This is not a transcript. No recording devices were allowed at the meeting, so this is based on many hours of rapid typing, combined with my memory. I have reorganized his comments by subject matter. Words in [brackets] are my comments or edits.

For my columns and notes on previous Berkshire and Wesco meetings, click here.

CHARLIE MUNGER RESPONSES DURING Q&A SESSION

Berkshire Operates With a Seamless Web of Deserved Trust

Everybody likes being appreciated and treated fairly, and dominant personalities who are capable of running a business like being trusted. A kid trusted with the key to the computer room said, "It's wonderful to be trusted."

That's how we operate Berkshire – a seamless web of deserved trust. We get rid of the craziness, of people checking to make sure it's done right. When you get a seamless web of deserved trust, you get enormous efficiencies. It's what the Japanese did to beat our brains out in manufacturing: suppliers, employers, the purchasing company, management – all created a seamless web of deserved trust. That's why we have firms – they create a seamless web of deserved trust. It's the same with good football teams.

Berkshire Hathaway is always trying to create a seamless web of deserved trust. Every once in a while, it doesn't work, not because someone's evil but because somebody drifts to inappropriate behavior and then rationalizes it. Our basic attitude is to create a seamless web of deserved trust.

How can Berkshire Hathaway work with only 15 people at headquarters? *Nobody* can operate this way. But we do.

Take Wesco. Every once in a while we get surprised by something – maybe once a decade. It's what we all want. Who in the hell would not want to be in a family without a seamless web of deserved trust? We try for the same thing in business. It's not rocket science; it's elementary. Why more people don't do it, I don't know. Perhaps *because* it's so elementary. We didn't copy the Japanese until they were clobbering us – and they copied from us!

Lowered Investment Standards at Berkshire Hathaway

At Berkshire Hathaway, we've lowered our standards a little – we're willing to invest with lower standards than in the past. We're not waiting for 1974 or even 1984. If you have the money, you have to invest it somewhere. It may well be that you have to take something that obviously promises a lower return than you were used to.

I think the people who say "I need more" and therefore try to get more than they need, are likely to get into terrible trouble. I know a man who owned his house free and clear, had $5 million of securities and lived on the income from those securities. But this left him a little short of what he wanted, so he said to himself, "I'll go do a little work to get my return up," and he sold puts, backed by his entire account. At the time, the highest price was on naked puts on Internet stocks and in due course he lost all of his money and now works in a restaurant.

We Buy With Reduced Expectations

Warren said at the annual meeting that with most of our present holdings, we're not buying or selling. And when we do buy, it's not, "Oh boy! A lollapalooza!" We buy with reduced expectations. How else can one behave? Would anyone want us to reduce Berkshire Hathaway's assets to cash and sit around waiting for a calamity so Berkshire can put the cash to work?

By No Means Have We Given Up on Putting Our Cash to Work

Warren answered this at the [Berkshire] annual meeting. By no means have we given up on putting our cash to work. And if we don't, the money is not going away.

Did You Predict Berkshire's Success?

Well, some of our success we predicted and some of it was fortuitous. [Regardless,] like most human beings, we took a bow. (Laughter)

Common Elements of Berkshire's Best All-Time Investments

Some eventualities came to pass. What the 15 best deals all have in common is that they all worked. There were different models – See's Candies was different from Shaw Carpets. But both are good businesses that will generate durable returns for the grandchildren of people sitting in this room. The reason I keep talking about the record without the 15 best deals is that it shows how few deals you need in a lifetime. The people who need a deal every month, by and large, they all crater. Patience and aggressive opportunism is what you need – an odd combination, but it's what works best.

Berkshire and Wesco Buying Back Stock?

Buffett answered this question [at the Berkshire annual meeting]. At some price, we'd buy back Berkshire, but it's quite a bit less than the price that currently exists. We're not looking for the chance to gleefully buy out shareholders at a substantial discount to its value. We like to behave so this doesn't happen.

As for Wesco, because you people have created this cult, it always trades at a premium to its liquidation value.

Bull on Berkshire

Despite my words, I'm a bull on Berkshire Hathaway. There may be some considerable waiting, but I think there are some good days ahead.

Stocks We're Buying

[I missed the rest of the sentence, but at one point Munger said: "…the stocks [plural] that we're buying today…"]

Problem of Buffett Foundation Having to Eventually Sell Berkshire Stock

I regard that as so easily solvable that I don't give two seconds to it. If the foundation has to sell 5% of its stock [every year to comply with the law that says all foundations must give away 5% of their assets each year], then Berkshire could pay a dividend or buy back the stock. It wouldn't bother me – we're drowning in cash. The needs of any one shareholder are easily dealt with in our current circumstances. You lead a very favored life if you worry about things like that.

COMMENTS ON BERKSHIRE HATHAWAY BUSINESSES

Advantage of Berkshire's AAA Credit Rating In Insurance

There's a little price tiering – there's a difference among insurers based on their credit worthiness. But is there enough difference? The answer is no. Do I expect a cascade of business to Berkshire Hathaway? No. But there's a modest and increasing trickle. People are not as credit-leery as they should be.

Pricing Super-Cat Insurance Policies

We're very peculiar. We don't have a department where we trust people to do it on their own. All decisions must be approved by Ajit Jain and Warren, and neither of them uses standard actuarial tables. In other words, after a long period with no hurricanes, the actuarial tables would tell you that the hurricane risk has gone down – that's not how they think at Berkshire Hathaway. There're very rational. We don't use standard actuarial tables, just as we start with [companies'] reported financials, but

then go from there.

You don't need dozens of people to write super-cat policies. So there's our plan: get Ajit Jain, add Warren Buffett working for free and then raise tens of billions of dollars because people trust you and there you go. (Laughter)

We Have Simple Compensation Systems

It isn't enough to buy the right business. You've also have to have a compensation system that's satisfactory to the people running them. At Berkshire Hathaway, we have no [single] system; we have different systems. They're very simple and we don't tend to revisit them very often. It's *amazing* how well it's worked. We wrote a one-page deal with Chuck Huggins when we bought See's and it's never been touched. We have *never* hired a compensation consultant.

Clayton Homes and the Disaster in the Manufactured Home Sector

The recent historical experience of mobile homes – actually, it's "manufactured"; they're not manufactured to move – is that you had a bunch of no-good nut cases and a balloon of unfortunate, commission-sales-driven activity. Any time you let people on sales commission set the credit standards for people using margin [e.g., debt to buy the home], you create a disaster. It's like mixing oxygen and hydrogen and lighting a match.

The homes deteriorated... It was an absolute disaster. If it hadn't been, we wouldn't have been able to buy [Clayton Homes]. [The distress in the industry was so great that] they were losing their securitization capacity. Clayton was the best, but even they were at risk so they sold to us.

What do you know about foreclosing on a house in a trailer park? And what do you do with it? We're now the largest in the country. I think it will work quite well for Berkshire and Clayton. If Clayton were an independent company, they'd have trouble. The people who claim we underpaid for it are out of their minds. It's amazing how many people think they know more than the people selling it.

Cort Will Be Successful Over Time

Cort benefited from the venture-capital-financed, new-company boom. You could argue that we made a macro mistake. These companies went away for a while and Cort was affected. But you can see in the first quarter earnings that it's coming back.

There's a class of people that just want to rent, not own. They are trying to be the Enterprise Rent-A-Car in the furniture rental business. It's not a gold mine, but we think it'll be successful over time.

INVESTMENT ADVICE

Behavior of Investment Managers

If you're an investment manager and they're going to fire you if you don't keep up with your benchmark, that can cause some weird things to happen in the markets as a whole. That's the world that we live in, whether you like it or not. It has some perverse consequences – for one thing, closet indexing. You're paying a manager a fortune and he has 85% of his assets invested parallel to the indexes. If you have such a system, you're being played for a sucker.

You have these fads in investment management. With so many bodies and minds and computers, I see figures of risk by asset class, but I don't have the faintest idea what they mean. They don't either, but they learned a fad, a way of thinking. If you learn a formula, you can run the numbers and print it up, but it doesn't mean anything.

Are Stocks Too High?

Too high is a funny word – they are high to those of us who are accustomed to finding real bargains. But it's not a promise [that there will always be such bargains]. I don't think it's unfair; I don't think it's too high in the sense that we're being deprived.

Our future prospects are way worse than what they used to be. But I'm 81; I've got bigger problems than diminished returns. (Laughter)

Spotting Bad People

It's hard to judge the combination of character and intelligence and other things. It's not at all simple, which explains why we have so many divorces. (Laughter) Think about how much people know about the person they marry, yet so many break up. It's not easy, it is in some cases. If people are splashing around with money like Dennis Kozlowski, with vodka at parties coming out of some body part, and if it looks like Sodom and Gomorrah, then maybe this isn't what you're looking for. (Laughter) But beyond that, it's hard. If you have some unfortunate experiences while getting that knowledge, well, welcome to the human race. (Laughter)

It's Tough to Make Money Investing in China

I think it's very tough to make money in China. A lot of terrible things can happen to you and you have no good antidote. China makes a lot of cheap well-made goods, but it could be that we won't have attractive investment opportunities in China even though the country may prosper.

We Want the Chinese to Get Richer

China is a nuclear power. We have no option but to have friendly relations with China – anything else would be really stupid. We *want* the Chinese to get richer and richer. I'm not unhappy that Wal-Mart is expanding in China.

Risk of a Calamity Investing in Currencies

I do think that it's conceivable that some enormously talented person that studied economics and relative value of currencies and devoted his life to it and only bet occasionally, that such a man could do very well [investing in currencies]. It's not my line of talent.

I'd rather do something that's not such a zero-sum game. If I invest in equities – the businesses are growing; for example, Wrigley's will make more gum. It's automatically working for me, even if I do nothing. But if I invest in currencies, it's not working for me.

If I had to make a living outside of equities, it might be in currencies. But I don't have to do it. There's less chance of a big calamity in equities. The problem with currencies is that it sucks you into margin, and then if it moves against you but you're sure you're right, it sucks you in deeper. And then one more twist of the screw…

If you're already rich, why would you live under such conditions? I think more people will do well if they follow the Warren Buffett model.

COMMENTS ON OTHER COMPANIES

I Think the Country Is Better Off for Having Wal-Mart

With Wal-Mart and the like getting so powerful, have we made a pact with the devil? My answer is I think the country is better off for having Wal-Mart. It's a fabulous enterprise that does a lot of good and delivers value to the customer and that's why it's successful. I think the country is better off for having this system for distributing goods.

When I go into Wal-Mart, I see elderly people as greeters – they're working part time and it gets them out of the house, but people say, "Isn't Wal-Mart nasty [for exploiting the elderly]?"

As far as I'm concerned, I think Wal-Mart does a lot of good with efficient distribution. I'm a director of Costco. Do we really want our entrepreneurs not to try very hard? Do we really want to wake and say, "Let's stop competing so hard?" I say, let winners run instead of investing in losers.

I like Wal-Mart's culture. As far as I'm concerned, Wal-Mart is one of the glories of civilization.

McDonald's Is a Great Educator

I get flack for saying [when I visit a college and give a speech], "This is a nice college, but the really great educator is McDonald's." They hate me for saying this and think I'm a slimy creature. But McDonald's hires people with bad work habits, trains them, and teaches them to come to work on time and have good work habits. I think a lot of what goes on there is better than at Harvard.

There's a Lot That Was Strong and Good at AIG

I've never examined AIG in great detail. AIG was run by a truly brilliant, dominant personality for a long, long time and had a fabulous record. I don't think we're going to find a fraud like Enron. Rather, a good company with a chieftain that maybe gilded the lily. I think he thought it was his duty to help along the reputation of AIG. I think he thought it deserved a better reputation than it had. I agree. I think every corporate chieftain feels the same way. I don't think it's blue smoke and mirrors.

I will miss Hank Greenberg dearly in areas like tort reform. He was always honest with us. He invited us or we invited him in the deal to buy the assets of Long Term Capital Management. There's a lot that was strong and good at AIG.

AIG, GE Credit and the Risks of the Carry Trade

That said, it's a lot like GE. It is a fabulously successful insurance operator, and with success it morphed into a massive carry business: borrowing a lot of money at one price and investing it at another price. AIG was a big operator that was a lot like GE Credit. We never owned either because even the best and wisest people make us nervous in great big credit operations with swollen balance sheets. It just makes me nervous, that many people borrowing so many billions.

As you can tell in our operations, we are much more conservative. We borrow less, on more favorable terms. We're happier with less leverage. They've been successful, but we're too chicken to join them. You could argue that we've been wrong, and that it's cost us a fortune, but that doesn't bother us. Missing out on some opportunity never bothers us. What's wrong with someone getting a little richer than you? It's crazy to worry about this.

There's a lot of leverage in those carry-trade games. Other people are more certain than I am that aircraft can always be leased.

I Would Never Dream of Shorting GM

I would never short a company that was doing $180 billion [in sales] per year with a market cap of $15 billion that was such an iconic part of America. I would never dream of making that short.

What happened was that a lot of very decent people running GM basically blew it. They were facing a very serious competitive challenge and they set up a [lifetime healthcare and pension] system that will grow and grow and grow and they are paying one hell of a penalty.

Employees have 5-6 times the value in their pension plan than all of the stockholders combined. [At the time, GM had a market cap slightly above $15 billion vs. approximately $90 billion set aside for pension liabilities.] GM gave all of the value of the company to employees and left shareholders with almost nothing. They didn't observe the maxim that a small leak can sink a great ship. They never should have allowed the unions to bargain with each company and shut one company down and let the other two take share. They should have bargained as a unit. The result today is a combination of what they gave away one year at a time.

I regard GM as such a marvel of human achievement, but also an example of massive management failure. I can't be criticized if I eventually die – I delayed it as long as I could. GM delayed it as long as they could. They had a very tough hand to play, but I would argue that they blew it.

I don't think Berkshire Hathaway will blow its hand in this way. It would never do that. We would do some very unpleasant things to prevent something that would have very bad consequences far into the future.

Nuclear weapons are a very serious problem. [It's so awful to contemplate that] people use gallows humor. What would you do if you were told a nuclear bomb would be detonated over Pasadena right now? The answer: you'd crawl under the table and kiss your ass goodbye. (Nervous laughter)

Comments on Leucadia and Its Investments in Telecom

We regard the Leucadia people as very smart. Is it conceivable that the Leucadia people could have one outcome that didn't work very well? Sure, it's possible.

I look at telecom and all the change and my reaction is that of Samuel Goldman: "Include me out." I'm just not suited for this; I don't know how to predict those outcomes, so I leave it to other people.

COMMENTS ON ECONOMIC MATTERS

Awash in Capital

It is weird the way that capital occurs. We have monetized houses in this country in a way that's never occurred before. Ask Joe how he bought a new Cadillac [and he'll say] from borrowing on his house. We are awash in capital.

[Being] awash is leading to very terrible behavior by credit cards and subprime lenders -- a very dirty business, luring people into a disadvantageous position. It's a new way of getting serfs, and it's a dirty business. We have financial institutions, including those with big names, extending high-cost credit to the least able people. I find a lot of it revolting. Just because it's a free market doesn't mean it's honorable.

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WESCO FINANCIAL CORPORATION

Annual Report 2005

Form 10-K Annual Report 2005

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated net ''operating'' income (i.e., before realized investment gains shown in the table below) for the calendar year 2005 increased to $77,973,000 ($10.95 per share) from $47,427,000 ($6.66 per share) in the previous year.

Consolidated net income increased to $294,579,000 ($41.37 per share) from $47,427,000 ($6.66 per share) in the previous year.

Wesco has four major subsidiaries: (1) Wesco-Financial Insurance Company (''Wes-FIC''), headquartered in Omaha and engaged principally in the reinsurance business, (2) The Kansas Bankers Surety Company (''Kansas Bankers''), owned by Wes-FIC and specializing in insurance products tailored to midwestern banks, (3) CORT Business Services Corporation (''CORT''), headquartered in Fairfax, Virginia and engaged principally in the furniture rental business, and (4) Precision Steel Warehouse, Inc. (''Precision Steel''), headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended			
	December 31, 2005		December 31, 2004	
	Amount	Per Wesco Share[2]	Amount	Per Wesco Share[2]
Operating earnings:				
Wesco-Financial and Kansas Bankers insurance businesses —				
Underwriting	$ 11,798	$ 1.66	$14,618	$2.05
Investment income	39,068	5.49	26,302	3.69
CORT furniture rental business	20,676	2.90	5,022	.71
Precision Steel businesses	1,198	.17	1,094	.15
All other ''normal'' net operating earnings[3]	5,233	.73	391	.06
	77,973	10.95	47,427	6.66
Realized investment gains[4]	216,606	30.42	—	—
Wesco consolidated net income	$294,579	$41.37	$47,427	$6.66

(1) All figures are net of income taxes.

(2) Per-share data are based on 7,119,807 shares outstanding. Wesco has had no dilutive capital stock equivalents.

(3) Represents income from ownership of the Wesco headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the insurance subsidiaries, less interest and other corporate expenses.

(4) Includes $216,112,000 ($30.35 per share) from the tax-free exchange of Wesco's common shares in The Gillette Company for common shares in The Procter & Gamble Company in connection with the merger of Gillette with Procter & Gamble. Although no cash was received, generally accepted accounting principles require that the gain be recorded. Because Wesco's balance sheet reflects investments carried at market value, with unrealized gains, after applicable income tax effect, included in shareholders' equity, the transaction did not affect Wesco's shareholders' equity. It merely resulted in a reclassification from unrealized gains to retained earnings, another component of shareholders' equity.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The foregoing supplementary breakdown is furnished because it is considered useful to shareholders.

The total consolidated net income shown above is, of course, identical to the total in our audited financial statements.

Insurance Businesses

Consolidated operating earnings from insurance businesses represent the combination of the results of their insurance underwriting (premiums earned, less insurance losses, loss adjustment expenses and underwriting expenses) with their investment income. Following is a summary of these figures as they pertain to all insurance operations (in 000s).

	Year Ended December 31,	
	2005	2004
Premiums written	$50,253	$45,042
Premiums earned	$49,482	$54,589
Underwriting gain	$14,566	$22,490
Dividend and interest income	55,889	36,058
Income before income taxes	70,455	58,548
Income taxes	19,589	17,628
Total operating income — insurance businesses	$50,866	$40,920

Following is a breakdown of premiums written (in 000s):

	2005	2004
Wes-FIC —		
Aviation pools	$29,118	$26,655
Property-casualty pool	—	(2,342)
Other	(64)	—
Kansas Bankers	21,199	20,729
Premiums written	$50,253	$45,042

Following is a breakdown of premiums earned (in 000s):

	2005	2004
Wes-FIC —		
Aviation pools	$28,391	$27,944
Property-casualty pool	—	6,244
Other	(53)	29
Kansas Bankers	21,144	20,372
Premiums earned	$49,482	$54,589

Following is a breakdown of after-tax results (in 000s):

	2005	2004
Underwriting gain —		
Wes-FIC	$ 6,787	$11,144
Kansas Bankers	5,011	3,474
	11,798	14,618
Net investment income —		
Wes-FIC	36,032	24,567
Kansas Bankers	3,036	1,735
	39,068	26,302
Total operating income — insurance businesses	$50,866	$40,920

As shown above, operating income includes significant net investment income, representing dividends and interest earned from marketable securities. However, operating income excludes investment gains of $216.6 million, net of income taxes, realized in 2005. No investment gains or losses were realized in 2004. The discussion below will concentrate on insurance underwriting, not on the results from investments.

Wes-FIC engages in the reinsurance business, occasionally insuring against loss from rare but horrendous ''super-catastrophes.'' In much reinsurance sold by us, other Berkshire subsidiaries have sold several times as much reinsurance to the same customers on the same terms. In certain instances but not always, such subsidiaries have taken from us a 3%-of-premiums ceding commission on premium volume passed through them to Wes-FIC. Excepting this ceding commission, Wes-FIC has had virtually no insurance-acquisition or insurance administration costs. In some cases, other Berkshire subsidiaries act as reinsurers at higher levels than the level at which Wes-FIC is reinsuring; terms of the reinsurance are considered to be fair or advantageous to Wes-FIC.

For the past several years Wes-FIC's reinsurance activity has consisted of the participation in two arrangements described below, the second of which was terminated in the fourth quarter of 2004:

(1) Participation, since 2001, in several risk pools managed by an insurance subsidiary of Berkshire Hathaway, our 80%-owning parent, recently covering hull, liability and workers' compensation exposures relating to the aviation industry as follows: for 2004, to the extent of 10% in the hull and liability pools; for 2005, 10% of the hull and liability pools and 5% of the workers' compensation pool. For 2006, participation in the hull and liability pools has increased to 12½ %. The Berkshire subsidiary provides a portion of the upper-level reinsurance protection to these aviation risk pools on terms that could result in the Berkshire subsidiary having a different interest from that of Wes-FIC under certain conditions, e.g., in settling a large loss.

(2) A multi-year contract entered into in 2000 through another Berkshire insurance subsidiary, as intermediary without profit, covering certain multi-line property and casualty risks of a large, unaffiliated insurer. This contract was commuted in the fourth quarter of 2004, at which time Wes-FIC paid the ceding company $43.1 million, cash, representing all unearned premiums, reduced by unamortized costs and expenses. After the commutation, Wes-FIC's obligation to indemnify any further insurance losses under the contract ceased. Under that contract for 2004, there was a net reduction in written premiums of $2.3 million; earned premiums were $6.4 million, and underwriting gain was $11.0 million ($7.2 million, after income taxes).

Wes-FIC's underwriting results have fluctuated from year to year, but have been satisfactory. When stated as a percentage, the sum of insurance losses, loss adjustment expenses and underwriting expenses, divided by premiums, gives the combined ratio. The combined ratios of Wes-FIC have been much better than average for insurers. Excluding the unusual beneficial effects caused by the commuted contract in 2004, Wes-FIC's combined ratios were 75.9% for 2005 and 77.8% for 2004. Although we have an appetite for unusually large risks when prices are satisfactory, thus subjecting

Wes-FIC to significant periodic underwriting losses, we try to create some underwriting gain as results are averaged out over many years.

Kansas Bankers was purchased by Wes-FIC in 1996 for approximately $80 million in cash. Its tangible net worth now exceeds its acquisition price, and it has been a very satisfactory acquisition, reflecting the sound management of President Don Towle and his team.

Kansas Bankers was chartered in 1909 to underwrite deposit insurance for Kansas banks. Its offices are in Topeka, Kansas. Over the years its service has continued to adapt to the changing needs of the banking industry. Today its customer base, consisting mostly of small and medium-sized community banks, is spread throughout 30 mainly midwestern states. In addition to bank deposit guaranty bonds which insure deposits in excess of FDIC coverage, KBS offers directors and officers indemnity policies, bank employment practices policies, bank insurance agents professional errors and omissions indemnity policies and Internet banking catastrophe theft insurance.

KBS increased the volume of business retained effective in 1998. It had previously ceded almost half of its premium volume to reinsurers. Now it reinsures only about 13%. The increased volume of business retained comes, of course, with increased irregularity in the income stream. KBS's combined ratios were 58.8% for 2005 and 74.9% for 2004. We continue to expect volatile but favorable long-term effects from increased insurance retained.

CORT Business Services Corporation (''CORT'')

In February 2000, Wesco purchased CORT Business Services Corporation (''CORT'') for $386 million in cash.

CORT is a very long established company that is the country's leader in rentals of furniture that lessees have no intention of buying. In the trade, people call CORT's activity ''rent-to-rent'' to distinguish it from ''lease-to-purchase'' businesses that are, in essence, installment sellers of furniture.

However, just as Hertz, as a rent-to-rent auto lessor in short-term arrangements, must be skilled in selling used cars, CORT must be and is skilled in selling used furniture.

CORT's revenues totaled $384 million for calendar 2005, versus $354 million for calendar 2004. Of these amounts, furniture rental revenues were $304 million and $275 million, furniture sales revenues were $72 million and $68 million, and apartment locator fees of its Relocation Central division, a business CORT started up in 2001, were $8 million and $11 million. CORT operated at an after-tax profit of $20.7 million for 2005, up satisfactorily from its after-tax profit of $5.0 million for 2004. These results reflect the favorable effects of several selective acquisitions.

When we purchased CORT early in 2000, its furniture rental business was rapidly growing, reflecting the strong U.S. economy, phenomenal business expansion and explosive growth of IPOs and the high-tech sector.

Beginning late in 2000, however, new business coming into CORT began to decline. With the burst of the dot-com bubble, the events of September 11, and a protracted slowdown in new business formation, CORT's operations were hammered,

reflecting generally bad results in the ''rent-to-rent'' segment of the furniture rental business. Obviously, when we purchased CORT we were poor predictors of near-term industry-wide prospects of the ''rent-to-rent'' sector of the furniture business.

CORT started up a new subsidiary during 2001, Relocation Central, which provides a large national apartment locator service through its websites, (www.relocationcentral.com and www.myrelocationcentral.com), customer call centers and walk-in locations. This start-up venture did not progress as rapidly as CORT expected and caused losses followed by some downsizing. Relocation Central was reorganized to become a division of CORT as of yearend 2004; it now relies more on Internet traffic and less on separate, fully-staffed facilities. The integration of Relocation Central into CORT was begun in 2003 as part of a program to reduce CORT's costs and thus enhance its operating results. CORT still likes the idea of having relocation services in its product mix. Almost twenty thousand apartment communities now refer their tenants to CORT.

We are pleased with the progress CORT made in 2005. We are cautiously optimistic that, in future years, we will be able to look back to the recent past and consider it merely a cyclical aberration in CORT's growth. We note, however, that the number of furniture leases outstanding as of yearend 2005 has fallen by about 4% from those one year earlier.

When Wesco paid $386 million for CORT, about 60% of the purchase price was attributable to goodwill, an intangible balance sheet asset. Wesco's consolidated balance sheet now contains about $267 million in goodwill (including $27 million from Wesco's 1996 purchase of KBS). The Financial Accounting Standards Board adopted a rule which became effective in 2002 that no longer requires automatic amortization of acquired goodwill. (The requirement for such amortization has been replaced by a standard that requires an annual assessment to determine whether the value of goodwill has been impaired, in which event the intangible asset would be written down or written off, as appropriate.) Earnings we have reported since 2002 more closely reflect microeconomic reality as we appraise it.

More details with respect to CORT are contained throughout this annual report, to which your careful attention is directed.

CORT has long been headed by Paul Arnold, age 59, who is a star executive as is convincingly demonstrated by his long record as CEO of CORT. We are absolutely delighted to have Paul and CORT within Wesco.

Precision Steel Warehouse, Inc. (''Precision Steel'')

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, operated at after-tax profits of $1.2 million in 2005 and $1.1 million in 2004. These figures reflect after-tax LIFO inventory accounting adjustments decreasing after-tax income by $.2 million for 2005 and $1.8 million for 2004. Precision Steel's operating results for 2004 also reflect expenses of $.2 million, after taxes, in connection with environmental cleanup of an industrial park where a Precision Steel subsidiary has operated alongside approximately 15 other manufacturers for many years. Had it not been for the LIFO accounting adjustment or the environmental matter, Precision Steel would have reported after-tax operating income of $1.3 million for 2005 and $3.0 million for 2004.

Precision Steel's business has been subject to economic cycles. Precision Steel has increasingly suffered from intensified competition resulting from a reduction in demand caused by customers' (or former customers') unsuccessful competition with manufacturers outside the United States. At the beginning of 2004, a shortage of raw materials from domestic mills produced near chaos in the domestic steel service industry. Domestic mills were operating at capacity and imported steel was not readily available. These and other factors enabled steel mills to raise prices, place limits on order quantities and extend delivery times. Prices of those raw materials were sharply increased and the price of finished steel also increased sharply. Customers of Precision Steel increased their purchases to counter allocations imposed by mills and other suppliers. Precision Steel successfully passed the price increases, plus normal markups, on to customers while favoring long-term customer relationships. Precision Steel's 2004 revenues increased 31.2% from those of 2003; pounds of steel products sold increased 14.5%. Throughout 2005, raw material supplies remained very tight, but competitive pressures increased as demand softened, possibly reflecting customers' absorption in their manufacturing processes of accelerated purchases made in 2004 in reaction to the chaotic market conditions. In 2005, pounds of steel products sold by Precision Steel decreased 8.6% from those of 2004, but revenues increased 1.4%, reflecting mainly 40%-higher average selling prices than those prevailing two years earlier. We are concerned that the favorable operating results experienced by Precision in the two most recent years may have been anomalous and temporary and that the steel warehouse business may revert to difficult times.

Although Precision Steel's figures for each of the past two years may signal improvement when compared with its after-tax operating loss of $.9 million for 2003 and $.3 million of income for 2002, it should be noted that conditions currently facing the steel service industry continue to be in a state of flux. The severity of the domestic downturn in the steel service industry is demonstrated by the fact that Precision Steel's average annual steel service revenues for the years 2001 through 2003 were down 27% from those reported for 1998 through 2000. Considering the improved earnings for 2004 and 2005, Precision Steel has still not reported satisfactory operating results in recent years. Its recent earnings compare unfavorably with operating profits which averaged $2.3 million, after taxes, for the years 1998 through 2000.

Terry Piper, who became Precision Steel's President and Chief Executive Officer in 1999, has done an outstanding job in leading Precision Steel through very difficult years.

Tag Ends from Savings and Loan Days

All that now remains outside Wes-FIC but within Wesco as a consequence of Wesco's former involvement with Mutual Savings, Wesco's long-held savings and loan subsidiary, is a small real estate subsidiary, MS Property Company, that holds tag ends of appreciated real estate assets consisting mainly of the nine-story commercial office building in downtown Pasadena, where Wesco is headquartered. Adjacent to that building is a parcel of land on which we have begun to build a multi-story luxury condominium building. We are also seeking city approval of our plans to build another multi-story luxury condominium building on a vacant parcel of land in the next block. We have recently begun to take reservations. Simply phone Bob Sahm (626-585-6700) for more information. MS Property Company's results of operations, immaterial versus Wesco's present size, are included in the breakdown of earnings on page 1 within "other operating earnings."

Other Operating Earnings

Other operating earnings, net of interest paid and general corporate expenses, amounted to $5.2 million in 2005, up from the $.4 million earned in 2004. Ignoring favorable income tax adjustments of $4.9 million, the sources of the $.3 million of earnings in 2005 were (1) rents ($3.5 million gross in 2005) from Wesco's Pasadena office property (leased almost entirely to outsiders, including Citibank as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiaries, less (3) general corporate expenses plus minor expenses involving tag-end real estate.

Realized Investment Gains

Wesco's 2005 earnings contained investment gains of $216.6 million, after income taxes. There were no realized investment gains in 2004. Of the 2005 gains, only $.5 million was realized through the *sale* of investments; the balance, $216.1 million, resulted from the tax-free exchange of common shares of The Gillette Company (''Gillette'') owned by Wesco, for common shares of The Procter & Gamble Company (''P&G'') in the fourth quarter of 2005 in connection with the merger of Gillette with P&G. Accounting standards promulgated by the Financial Accounting Standards Board require that the fair (market) value of shares received in such an exchange be recorded as the new cost basis as of the date of the exchange, with the difference between the new basis and the historical cost realized in the audited financial statements as an investment gain. For tax return purposes the exchange is recorded at the original cost of the securities exchanged; no gain is reported, and no taxes are yet due.

Although the realized gain had a material impact on Wesco's reported earnings, *it had no impact on Wesco's shareholders' equity*. Wesco carries its investments at fair value, with unrealized appreciation, after income tax effect, included as a separate component of shareholders' equity, and related taxes included in income taxes payable, on its consolidated balance sheet. Thus, the entire after-tax gain on the non-cash merger had been reflected in the unrealized gain component of Wesco's shareholders' equity as of September 30, 2005. That amount was merely switched from unrealized gain to retained earnings, another component of shareholders' equity. This accounting entry had no economic effect on Wesco, and you should ignore it when you are evaluating Wesco's 2005 earnings.

Consolidated Balance Sheet and Related Discussion

As indicated in the accompanying financial statements, Wesco's net worth, as accountants compute it under their conventions, increased to $2.23 billion ($313 per Wesco share) at yearend 2005 from $2.12 billion ($297 per Wesco share) at yearend 2004. The main cause of the increase was net operating income after deduction of dividends paid to shareholders.

The foregoing $313-per-share book value approximates liquidation value assuming that all Wesco's non-security assets would liquidate, after taxes, at book value.

Of course, so long as Wesco does not liquidate, and does not sell any appreciated securities, including the P&G shares Wesco received in connection with P&G's acquisition of Gillette, discussed above in the section, ''Realized Investment Gains,'' Wesco has, in effect, an interest-free ''loan'' from the government equal to its deferred income taxes, subtracted in determining its net worth. This interest-free ''loan'' from

the government is at this moment working for Wesco shareholders and amounted to about $36 per Wesco share at yearend 2005.

However, some day, parts of the interest-free ''loan'' may be removed as securities are sold. Therefore, Wesco's shareholders have no perpetual advantage creating value for them of $36 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than $36 per Wesco share.

Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway. Moreover, the quality disparity in book value's intrinsic merits has, in recent years, continued to widen in favor of Berkshire Hathaway.

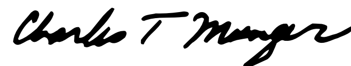
All that said, we make no attempt to appraise relative attractiveness for investment of Wesco versus Berkshire Hathaway stock at present stock-market quotations.

Wesco's consolidated balance sheet reflects total assets of $2.7 billion as of yearend 2005. Of that amount, more than $1 billion has been invested in cash equivalents and fixed-maturity investments since early in 2003. Unless those funds can be attractively reinvested in acquisitions, equity securities or other long-term instruments of the type that have been responsible for the long-term growth of Wesco's shareholders' equity, future returns on shareholders' equity will probably be less than those of the past. Due to the current size of Wesco and its parent, Berkshire Hathaway, Wesco's opportunities for growing shareholders' equity are unlikely to be as attractive as in the past.

The Board of Directors recently increased Wesco's regular dividend from 35½ cents per share to 36½ cents per share, payable March 2, 2006, to shareholders of record as of the close of business on February 1, 2006.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Shareholders can access much Wesco information, including printed annual reports, earnings releases, SEC filings, and the websites of Wesco's subsidiaries and parent, Berkshire Hathaway, from Wesco's website: www.wescofinancial.com.



Charles T. Munger
Chairman of the Board
and President

March 2, 2006

Whitney Tilson's 2006 Wesco Annual Meeting Notes:
Part 1, Charlie Munger's Opening Remarks

May 11, 2006

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***Note**: Words in [brackets] are my comments, edits or, when I missed something, my best guess of what was said. Part 2 of these notes, from the Q&A session with Mr. Munger, will be completed soon.*

For my columns and notes on previous Berkshire and Wesco meetings, click here.

OPENING REMARKS

Welcome to the Wesco annual meeting for the die-hard groupies of Berkshire Hathaway. [Laughter]

[Munger briefly went through the official business of the annual meeting, introducing the directors, etc. At one point, he said that there are 7,119,807 shares of Wesco outstanding, and commented: "That has not changed since I was first affiliated in any way with Wesco. We must be the only corporation in America with that attribute." He then concluded the annual meeting and, as he's done in past years, began with some remarks, after which he took questions for roughly two hours.]

Now we will begin our question-and-answer session, preceded by extended comments … by me. [Laughter]

The reason I'm making these extended comments is that so many of you have come from so far and so many of you are devotees of the same approach to life as is demonstrated around Berkshire and Wesco. Under these circumstances, I feel obliged to do it as an unfortunate aspect of my duties. It's not entirely an unpleasant duty because I like people to think the way I do.

The Money Management Fad

One unfortunate aspect of my practice is that I talk to a great many money managers who want to do better – do their function in life way better than other people do. I have very mixed feelings on this subject because I regard the amount of brainpower going into money management as a national scandal. We have armies of people with advanced degrees in physics and math in various hedge funds and private-equity funds trying to outsmart the market. A lot of you older people in the room can remember when none of these people existed. There used to be very few people in the business, who were not very intelligent. This was a great help to me. [Laughter]

Now we have armies of very talented people working with great diligence to be the best they can be. I think this is good for the people in it because if you know enough about money management to be good at it, you will know a lot about life. That part is good.

But it's been carried to an extreme. I see prospectuses for businesses with 40-50 people with PhDs, and they have back tested systems and formulas and they want to raise $100 billion. [Munger is referring to Jim Simons, who has compiled one of the best investment records of all time with Renaissance Technologies, compounding net to investors at roughly 35% annually since 1982.] And they will take a very substantial override for providing this wonderful system. The guy who runs it has a wonderful investment record and his system is a lot of high mathematics and algorithms with data from the past.

Rationality is a High Moral Duty

What is the central theme that the people in this room represent? I'd argue that it's rationality rather than to make more money than other people. I'd argue that rationality is a high moral duty. It's the idea the binds us all together. I think that is a *really* good idea. It requires that you avoid taking in a lot of the nonsense that's conventional in your time. There's always a lot of nonsense in anyone's time. It requires gradually developing systems of thought that improve your batting average and thinking correctly.

Regarding Wesco, there's not much to say beyond what's in the annual report, so I won't talk about it unless I'm asked a question.

Regarding money management, I'll talk at some length because we're in quite a period. When I was young, professional money management consisted of owning some mixture of stocks and bonds. Early on, bonds were respected and stocks were regarded with some fear, thanks to the early 1930s and the behavior of the capitalists in the robber-baron days. For a long time, stocks yielded dividends that were twice as much as the interest rates on bonds. It was a wonderful period to be buying stocks. We profited from others' demoralization from the previous generation.

Today's System of Institutional Money Management is Nuts

It used to be that if you owned stocks, you could get an extra 7-8 points of return per annum, but if you think that's true today, you probably believe in the tooth fairy. If there's any efficiency at all in markets, all of these professionals will have asset-class [returns] converge.

As this convergence became obvious to a lot of people at foundations and pension funds, they basically said "It won't work very well for me if I get lower returns, because I need and want [higher returns]." So they reasoned as follows: "I need it

and I want it and therefore I should have it." [Laughter] My father used to have contempt for this attitude.

So institutional investors have decided that they want way more than the result that can be achieved from the standard mix of stocks and bonds. So the system morphed into a series of consultants. The consultancy system works as follows. It's like a gigantic farm, stretching as far as the eye can see. They decided to manage this farm in an intelligent way and somebody had to decide how much soybeans to have, how much corn, wheat, pigs, chickens, etc. Once we decided to do that, then we decided to subdivide responsibilities by having a competition. Those who think they're excellent chicken raisers will compete for the job of raising chickens. All the guys who think they know how to grow soybeans will compete for the job of growing soybeans, etc. And then they have these beauty contests judged by the consultants. Those of you in money management are no doubt familiar with this process.

The interesting thing about this, the reasons that it spread so mightily, is because it coincided with a time when stocks and bonds were collapsing and disappointing, so a lot of the people who'd gone to this system profited. The truth of the matter is that there were remarkable opportunities from taking leveraged positions. There was a time when junk bonds, purchased with reasonable care, produced enormous returns [he's referring to the collapse and near paralysis in the junk-bond market in late 2002]. And the same thing in different forms also generated big returns.

I recently met a man with more than $5 billion under management. Institutions found him via consultants, incidentally, even though he's not that hard to find. [Laughter] What he does is buy participations in first-lien bank loans, probably $50 million a pop, and he selects the ones he thinks won't default, and he gets 250 [basis points] over LIBOR. Then he issues bonds against his purchases until he's leveraged about 6x. These are 10-year bonds that can be prepaid at will but can't be called. The bonds yield a little bit over LIBOR, so maybe he's getting a two [percentage] point override. You don't have to know very much about mathematics to know that this yields a very handsome return on the equity of the people who put it up. So the institutions put up the equity and this man takes a nice fee and 20% of the profit. So far, there have been no defaults and the institutions have gotten over 10% per annum – and the guy's gotten rich.

I see this repeated over and over and over again. So why don't we all leverage someone's high-yielding loans and make our own 12 or 13 or 20% with our own money.

In the first place, it's inconvenient to do. You have to work at it, understand the covenants. I regard what this man is doing as pretty intelligent. Taking first-lien positions, it's not totally crazy. My guess is that investing with this man is not the dumbest thing these institutions are doing. It has some elements of rationality. It's worked very well, but it's created a lot of leverage in the system. If there was a real convulsion of some kind, all of these things would encounter trouble. But short of a

convulsion, everything would be okay. It's sort of like earthquake insurance. Most years when you write earthquake insurance, you pocket the premiums and look very intelligent. If you do that with someone else's capital under a profit-sharing formula, it would *really* be intelligent.

All of this stuff that people are investing in – it's like the man who promises you an extra yield on a bond, provided there's no major earthquake (earthquake in some general sense). The investment world is just chock full of this stuff and it's worked very well so far. Everyone's made a lot of money. The people like Harvard, who got into fixed-income arbitrage *really* made a lot of money. The rest of us were asleep when Harvard was doing this. It wasn't that hard when they told us that interest rates were going down, down, down for a long time. There was an easy, idiot-proof way to take advantage of this, with very little risk, but it involved using unconventional techniques, using the [bond] repo system to go long 2-year Treasuries and go short 1-year Treasuries on a highly leveraged basis. People got very rich on carry trades like that. They not only made a lot of money on the interest, but also on the valuation as the interest rates kept coming down. These unconventional people suddenly got very good investment records, partly by accident.

The Early-Stage Venture Capital Fad

Take the world of venture capital. A few people like Harvard and Yale concentrated their investments with the four or five early-stage venture capital firms that had a real edge because they were the best known, attracted the best brainpower, and got the first calls from the companies. If you look at the history of start-up venture capital, you will find that a very few firms made most of the money, and they made it in just a couple of boom periods. Practically everyone else in a different period made mediocre or lousy returns.

Of course what happened was that when the huge returns were made by the clients of these few firms, envy rippled through the world of institutional money management and everyone set out to enter the business and firms started up to meet this demand for early-stage venture capital investment. In 1999 and early 2000, the amount invested was up about 10x. A lot of money was lost and I think something like this will happen again with these latest fads.

Many of you are on investment committees and I don't know anybody who has successfully resisted this. There's a new orthodoxy: you take all of the different fields of investment and somebody decides how much money is going into each field. And then you have these beauty contests, deciding who's going to manage the money in the distressed debt, early-stage venture capital, small caps, developing countries, etc., etc., etc. The people feel so busy and so virtuous, particularly after they've been successful for a while and other people who led them into it were also successful. You can put me down as an enormous skeptic to this whole process, even though it's worked so far.

I don't see anything automatically wrong with doing some fixed-income arbitrage at selected times just because it was unconventional for some institutions to do it. I don't think it's wrong to engage in some activities in foreign countries or emerging markets or a lot of other places.

But this idea that you have these categories and then look for the right masters of the category – that is nuts by the standards of Berkshire Hathaway and Wesco.

Opportunity Costs

The introductory text in economics, the best-selling one by [Harvard Professor Gregory] Mankiw, says that all intelligent people make decisions based on their own personal opportunity costs. So, when someone presented a company in an emerging market to Warren Buffett, Warren said, "I don't feel more comfortable [buying this] than I feel about adding to our position in Wells Fargo." He thinks highly of the company and the managers and the position they were in. He was using this as his opportunity cost. He was saying, "Don't talk about anything unless it's better than buying more Wells Fargo." It doesn't matter to Warren where the opportunity is. He has no preconceived ideas about whether Berkshire's money ought to be in this or that. He's scanning the world trying to get his opportunity cost as high as he can so his individual decisions would be better.

Why is it that the prevalent investment course in economics, what this Harvard professor [Mankiw] says, is so inconsistent with what *all* of these experts are doing? I have difficulty understanding it. It's because of crazy waves of mental conformity and based on social approval. I believe in it the way I believe in baptism, because I've seen it done. [Laughter]

It's hard for me to think that this many smart people can be so extremely irrational. This worshipping at the altar of diversification, I think that is really crazy. The idea that 10 different securities might not make an institution or a family securely rich? Yet instead they listen to the professionals recommend having 300 securities in separate accounts, with cadres of experts and battalions of consultants, all charging them money and that is going to make them safe?! How can people be so uncynical about human nature?

Some of you may remember when a group of experts developed the idea of portfolio insurance. They created this trip hammer system and that gave us Black Monday and the market fell 20%+ in one day. Of course the idea just died with this one denouement.

If you listen to the presentations of the people who are selling these various forms of expertise, they seem like reasonable people and you listen to their presentation and you walk away wanting to invest money with all of them. These people are selected because they know how to tell a beguiling story.

This system, with all the costs of getting in and out, with all these layers and experts and so forth, in many cases exceeds 3% per annum in costs. In a world when government bonds yield 5% and when returns from other assets are very likely to be converging toward 5%, that's likely to eat up more than half of the expected return. You could have a lot of disappointment in America.

Everyone thinks they've found a way to rig the game. After all, Harvard doubled and tripled its endowment. So people say, I've seen the excellence at Harvard, so I want to get a high return, and there are these other people who tell them they know how to do it. And if you look at the last four or five years, they've done it. They are in for quite a ride I think.

A Different Construct

Let me give you a different example, a different construct. I know a man, John Arrillaga [#346 on the Forbes 400], who was a star athlete at Stanford in a different generation. He got out of Stanford and started building little buildings around Stanford. He kept doing it and was good at it and of course there was no better market. In due time, he and his family had 15 million square feet, and the rents had gone up and up and up.

The interesting thing was that instead of doing the normal thing real estate developers do, which is borrow, borrow, borrow, so that money earned goes up and up and up, John gradually paid off 100% of the debt on his buildings so that when the great Silicon Valley crash hit and three million square feet of his buildings went vacant, it was a total non-event – and, in fact, he could start buying buildings from others [who were distressed]. He now likes to build buildings for Stanford – and doesn't take any compensation for it; he takes a loss. This has been a wonderful thing.

Here's a man who deliberately took some risk out of his life. He has no regrets in his life. He was damn glad. I think there's a lot to be said when the world is going a little crazy around you, to at least put yourself in a position that if something really unpleasant happens, that it might be unpleasant but will be a non-event in terms of changing your life. We all might consider imitating John Arrillaga as things get crazier and crazier.

How Crazy Are Things?

Well, how crazy are things? Let's look at the obvious bubbles. Saudi Arabia had a huge bubble; it was the South Sea bubble all over again. People bought into things just because they were going up, and the market is down 50%. Kuwait did the same a few years ago. There was just an orgy like the South Sea bubble. But Kuwait is so rich that when it happened, they just bailed everybody out.

The wealth of some of these oil countries is amazing. Qatar decided it wanted a medical school and 300-bed hospital. It cost $9 billion and it was like taking it out of

petty cash. In the history of the earth, I don't think there's ever been so much wealth per capita – and it's only about 60 miles square. The world is not entirely a fair place when it leads to these ridiculous bonanzas.

I remember a story they used to tell in Texas when I was young. When some idiot got rich, they'd say, "Well, old Charlie was out in the field playing the big brass tuba on the day it rained gold." A lot of people have become rich lately who were playing the tuba on the day it rained gold.

If you get capital gains taxed at 15% and you get stock options in something that goes crazy or a hedge fund that has a great year…There's many a man that decides he wants three Chagalls and a $15 million apartment very fast…

The world has signs now that are somewhat disturbing. The way things are going is that every asset class I see is priced on a fairly rich basis.

If you buy a really nice apartment house, with the costs of running it and replacing carpets, etc., it yields less than 5% if you buy it outright. In Europe, you can find office buildings that are yielding 3%.

There are very liberally valued assets in practically every asset class. Junk bonds seem to be pretty junky. Whatever premium they're providing in terms of yield seems to me to be offset by the increased risk of not getting your principal back.

The markets are picked over. Part of the reason they're picked over is because so many people like you can afford to come so far and think about value investing.

Even Obscure Markets Are Picked Over

Little obscure markets are picked over too; it isn't just the big ones. I heard of a money manager who made a presentation to a major university the other day. Guess where he'd generated a successful investment record? Sub-Saharan Africa! There is a specialist in investing in sub-Saharan Africa. And, by the way, he's done very well. It's kind of like Ben Graham – he just picks some field that nobody else is interested in.

The headlines are so awful in sub-Saharan Africa. He just went into these relatively illiquid securities and dominated every little pocket and made $500 million. It's quite rational. If a thing is despised enough and ignored enough, you can run a Geiger counter over it and find a few things that make it go click. But he had no illusion that he could make another $500 million in sub-Saharan Africa. He'd accomplished what he was trying to do for a while in the field he'd chosen.

I think that's what you find around the world. Even if you did go into sub-Saharan Africa, which not many people are likely to do, you'd find the field pretty well

occupied. And this is a guy who thinks a lot the way you do and he knows everybody and that's pretty much the way you'll find the world.

The World Has Changed (Buffett's Investment in South Korea Notwithstanding)

Warren, liking examples that markets are not all that efficient, is now telling business school classes and others that a few years ago he looked at the Moody's manual for South Korea [and found a lot to invest in]. There's a nuclear North Korea to the north, huge scandals at home, chaebols that didn't seem to care about the shareholders, a huge consumer credit boomlet that led to a huge collapse. And in the middle of that, Warren found a flour mill trading for two times earnings and he thought he was young again. [Laughter]. So he bought a lot of these securities right out of the manual and made a lot of money. So [he concluded], the world hasn't changed.

Well, the world *has* changed. If you're Warren Buffett, maybe you can find the one place where that still works, but I don't think many ordinary people can find a great many pockets as crazy as South Korea [was].

Macro Problems – Consumer Credit

Now you have the problems of the macro scene. Let's take credit expansion. Consumer credit has expanded to levels that nobody's ever seen before. All of these credit cards and all of these algorithms… people [meaning lenders] really want that particular customer that's just crazy enough to overspend but not so crazy that he goes bankrupt. [Laughter] They have computer algorithms to identify these people – they seek them out with clever marketing techniques. I always say it's like having serfs when you finally get them. They while away at their job and you're the lord of the manor and at the end of the month they send you [the money they make]. They've gotten so rich that [the lenders] keep surfing for more serfs with ever more liberal credit, and so forth. That is the world of consumer credit.

Mortgage Credit

Now you get into mortgage credit. Again, to the people in this room, this is a new world. Warren sold that house in Laguna that he'd owned for many years. He asked the buyer how much he'd borrowed for the $3.5 million or whatever the house cost, and he said 100%. He got an 80% loan and then got an equity line and with a little manipulation, he could borrow 100%. Now you have all these mortgages that say that if it's inconvenient to pay the interest, it's no big deal, just add it to the principal and you can get to it later. [Laughter] You not only don't have to pay the principal, you don't have to pay the interest! Of course, with this arrangement, you can buy a lovely spread.

And the accountants let people write mortgages like that and let you accrue substantially all of the income even though the credit risk has obviously gone up.

And they do that because they can't see any difference in the credit losses yet. That is not the way I would do accounting – but a lot that I see is not the way I would do accounting.

It was quite logical for people to gamble that with interest rates going down, housing prices would go up. And if you really took advantage of the low interest rates and really laid it on and took on a lot of leverage, I think that was very clever and you could even argue it was totally sound. People did it big time and made *enormous* amounts of money – *unbelievable* amounts of money. The rest of us were really dumb. It was a very logical thing to do if you stop to think about it: as interest rates were sure to go down, the value of property was sure to go up. The rest of us were stupid. It looked risky, but really wasn't. It was a pretty smart thing for these people to do.

Whether it's smart to continue it now from our present level is a very interesting question. I would think no. There are many instances of collapse after liberal mortgage lending. England had a tremendous collapse maybe 10 or 15 years ago.

A combination of very extreme extra leverage in mortgage lending, combined with the leverage in consumer lending…

Commercial Real Estate Lending

Let's talk about commercial lending to real estate developers. A good friend of mine just invested in a very intelligent real estate development project, with a good developer. The total development is going to cost $140 million. And guess how much non-recourse equity the developer put up? $8 million! I don't care how promising the real estate market is – if you leverage something that much, there could be a lot of pain for the real estate lenders.

We are in a weird period. I think it's extra dangerous because it's worked so marvelously well for everybody who did these loony things in the past. Everything's worked.

Silicon Valley Bubble

People really got creamed who were the marginal players in the early stage venture capital business. Some of them have not recovered and have even disappeared in the collapse in Silicon Valley. But that was an unbelievable bubble.

I negotiated with a young woman at the height of that, thinking she should come work for us. She was 23 years old and in her second job and had Silicon Valley stock options. She said, "My stock options are now vesting at the rate of $40,000 a week," so we'd have to start compensation to offset that before she'd consider changing employment. [Laughter] By the way, her brother was a Ph.D economist at some reputable university and he was looking at his sister earning $40,000 per week and

thinking this was not part of economics when he was learning it. [Laughter] But at any rate, that's the weird situation we're now in.

Wesco and Berkshire Still Holding and Occasionally Buying Stocks

Obviously, since Wesco and Berkshire are still holding stocks and occasionally adding to something, we'd rather own selected common stocks at these prices rather than own, say, municipal bonds long term – we're at least that optimistic. And we think we'll find occasional things to do where we'll earn returns at least moderately approaching some of the things we did in the past. That's my role as a director, to orient you to the way the world looks to me.

How Stupid We Were

The proper thing to do looking back is to realize how stupid we all were. We all blow a fair amount of obvious opportunity. By the way, Berkshire did do some fixed-income arbitrage and distressed debt. It's not like nothing at all has gone on in recent years. But looking back, I would say that we were all a little bit brain blocked – we could have done better in recent years. The right way to do it, of course, is to scan a broad area until you find something you understand and that you're sure will work and then load up hugely, after properly considering other opportunities. Most of us, including the one speaking, didn't scan enough. I didn't try as hard as I did when I was young. We should have scanned a little more intelligently and been a little more ambitious in the things we did.

I don't think it's a game that everybody will win at. The mistakes we all made were pretty much standard in human nature. Most people are way worse at making decisions than the people in this room.

I said at the Berkshire meeting that the money managers and stock brokers – it's not a class where everybody's wonderful and angels – but those who tend to come to our meetings I always feel are the class in their group. I think Berkshire and Wesco, in their meetings, attract a very good class of money managers who try to be rational and do a good job and not go crazy. I think that's why you're here. It's kind of like a reaffirmation of the faith.

Well, with those preliminary remarks, I will now open the field for questions.

[*Part 2 of these notes, from the Q&A session with Mr. Munger, will be made available soon.*]

Whitney Tilson's 2006 Wesco Annual Meeting Notes
Part 2, Question and Answer Period

May 11, 2006

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***Note**: Words in [brackets] are my comments, edits or, when I missed something, my best guess of what Mr. Munger said. Part 1 of my notes, from Mr. Munger's opening remarks, were sent out earlier.*

For my columns and notes on previous Berkshire and Wesco meetings, click here.

MY QUESTION

[I asked the second question of the meeting and Mr. Munger gave a lengthy answer, touching on many of his favorite topics: the failure of corporate governance, the importance of good accounting – and the failure of accountants to uphold this, etc.]

My question: Hello Mr. Munger, I'm Whitney Tilson, a shareholder from New York. [Mr. Munger: "I know you well."] Thank you. My question relates to something you and Mr. Buffett said at the annual meeting last Saturday. Mr. Buffett spoke at length about the need for improved corporate governance and that large shareholders really need to step up and start behaving like owners rather than renters. I forget whether it was in the context of that question that you said something along the lines of activist hedge funds being a mixed bag.

It struck me that there might be some inconsistency in those statements because in the past two or three years, virtually every case in which I can think of in which a large shareholder acted like an owner – the only exception I can think of is in the case of Hollinger and Chris Browne and the Tweedy Browne folks, but even that was an accident and they hope never to be activists again – the only people who are behaving as you are calling on shareholders to behave are, in fact, these hedge funds. I know what you think about hedge fund fees and that they're likely to underperform as an asset class – and I wholeheartedly agree, despite running one of these creatures – but my question is: at least in the area of corporate governance, shouldn't you and Mr. Buffett be applauding this kind of behavior (while perhaps holding your nose about the fees these funds charge) and encouraging institutional investors and mutual funds to behave in this fashion.

Munger's reply: The reason I said it was a mixed bag is because I regard it as a mixed bag. Obviously, since Hollinger was a total kleptocracy [laughter] – I mean *total*; it was the most god-awful example of corporate misbehavior that you could imagine – and it was contrary to Tweedy Browne's interests to do what it did, when they cleaned up that mess by wading in big-time, they did the rest of us a favor. So that's the part of the mixed bag that's weighted toward the favorable side.

But if you take Carl Icahn's assault on Time Warner – if you think Carl Icahn really gives a damn about the shareholders of Time Warner… Tweedy Browne was revolted by the behavior and so they got on a real moral crusade. And they were right, and I applaud that. But a lot of other people just want to raise hell and they don't care if they're raising hell with admirable people or knaves – they're just trying to make money. That second class is I think a mixed bag that we don't need.

I don't think every corporation in America that could be, on a short-term basis, made to give shareholders a little jump in value…I don't think every single instance like that ought to be seized by the management or whether shareholders ought to have the power to run around and do it, particularly if they're the [wrong kind of people?].

I think I said on a previous occasion that some of these assaults remind me of Oscar Wilde's definition of fox hunting: he said it's the pursuit of the uneatable by the unspeakable. [Laughter] In other words, I think some of the hedge fund types are the unspeakable and even when they're on the right side, the other people are uneatable. But still it's not an elegant view. The Tweedy Browne thing was a huge blessing – I'd agree with that.

Corporate Management and Governance
Governance is a very tough subject and the truth of the matter is that corporate managements, from shareholders' point of view, run the gamut from being very valuable, so they add to the asset value of the business they supervise, to very negative, so that the asset value of the business should have a big discount. You know that perfectly well in your own life. One of our fellow value investors said the other day, considering the self-interested way that most corporate managers behave, you *ought* to get 30-40% more assets than you pay for to allow for the depravations of the people who are running the corporation. [Laughter] That's a very harsh thing to say, but it's true in many cases.

Compensation and Stock Option Abuse
There were *lots* of companies that had something like 50% of all of the outstanding stock subject to options. They couldn't help it. They were in the high-tech game, everybody else was paying in options, and they needed people like this woman who was making $40,000 per week in options, so they paid in this currency and were just swept along by these crazy practices. Corporate compensation is a weird subject.

Stock Option Accounting: The Accountants Failed Us
Again, the accountants failed the rest of us. Never, ever should the accountants have allowed any stock option compensation not to go through the income statement, 100%, all of it. The Washington Post has a subsidiary where they created a phantom stock option plan in which somebody valued the subsidiary as a public company and the employees get options. But they account for that on a full-cost basis, not the way people are now accounting for the cost of stock options, which is to hire phony experts to come up with low values. They resented the fact that options had to be expensed, so they made very foolish assumptions so they could get the charges as low as possible. And they're

still lobbying to try to get Congress in some way to change the accounting back to its former knavish state.

Accounting Has Huge Consequences
Accounting has *huge* consequences because given the competitive pressures in life, you have enormous incentives to report every damn item of income they possibly can. People who are subjected to that kind of temptation need a disciplined supervisory structure, which accounting provides. I feel sorry for my individual friends in the accounting profession who haven't produced any income for years because of the malpractice fines, but the profession as a whole richly deserves the amount of trouble that it's had. It's *such* a thankless job to want to pull the plug. How many people are volunteering for that? It reminds me of the saying, "Whose bread I eat, his song I sing."

Sarbanes-Oxley
The Sarbanes-Oxley stuff did give us a little bit of supervision over accountants but what they're doing mostly is running around improving internal controls, which is a gold mine for the accounting firms. Companies need bodies and the accounting firms are billing those bodies at very high rates (despite the quality of some of them), so it's been a bonanza for the accounting profession. And I think better internal controls are ultimately good.

Implications of Bad Accounting: The Enron Disaster
But some of the big stuff is being ignored. I had fun once at the Stanford Directors' College [a program at Stanford University to train corporate directors on how to be good directors] – I asked them, "Name the time when that whole Enron thing could have easily been stopped?" People utterly failed – they should have done better. A whole bunch of experts paid thousands of dollars to come to the college, but not one person stood up with the correct answer, which is: that when Skilling got to SEC and talked them into allowing them to front-end all future profits from long-term arrangements to deliver natural gas and the income immediately went to the trading desk. This triggered a whole daisy chain, with all of its misery and terrible example. And all they had to do is make that one decision right instead of wrong. What I've said is totally obvious, but I don't know how many other people realize it – and this is a smart bunch. It's so *easy* to realize how all of this sin and error could be fixed by proper accounting. Yet the skilled people like Skilling and Arthur Andersen went to talk to the skilled regulators who are the accountants at the SEC and they made the exact wrong calls.

There's a lot to be fixed in the world. To the extent that this is an educational meeting, I think the story I've told you is giving you a real educational lesson. It would have been *so* easy…yet the method they chose was so insane. I'll give anybody with any understanding of traders and trading culture and management consulting and management consulting culture, how could *anyone* believe that that kind of accounting would be anything but a disaster?!

There's so much skill in exposition in this stuff. Look at Johnnie Cochran. There's just a huge amount of skill in exposition. And part of being a wise person is resisting the other

person's expository – to know nonsense when you see it. If you're like me, you can conceal your contempt for the person even as they speak. [Laughter]

I think we can offer a certain forgiveness. It reminds me of the [?] who was confronted with the scandals of the Catholic church. He said, "Well, I've had my scandals too. It just happens because of our different doctrines. Most of mine are heterosexual." [Laughter] And I said, "Well, I can understand why the Catholic church got into so much trouble, because of all of the religions, they're the one that's most into forgiveness. A person can be redeemed. How about you?" And he said, "Oh Charlie, I forgave every single one [because of what's it's like to live somewhere else?]." Well, that's the wonder of forgiveness. [Laughter]

COMMENTS RELATED TO BERKSHIRE HATHAWAY

Comments on the Reinsurance Business

I think the reinsurance business is a very difficult business. And it's a very tempting business, in which a guy writes you really large checks in advance. That kind of field will lead to a lot of dumb stuff and a lot of calamities. It takes exceptional skill to do well in reinsurance over the long term. Few people can do it.

So you might ask, Why do we think we can do it? Well, we're not everybody else. [Laughter] If you stop and think about it, that's the only logical answer. The only other alternative is that we're nuts, a possibility you'll have to consider. [Laughter]

What is Berkshire's Formula for Pricing Super-Cat Insurance?

The answer is, there is no formula. Ajit [Jain] and Warren are like father and son in how they interact. They're like a couple of bridge players. Anything they want to do is okay with me. You should be so lucky to have Ajit Jain and Warren Buffett doing this for you.

What Investment Hurdle Rate Do You Use in Your Models When Deciding Whether to Make an Investment?

We don't do a lot of involved math with schedules of investments. Certainly we expect a decent return or we don't do it. We use a lot of experience and do it in our heads. We distrust others' systems [and complex models] and think it leads to false confidence. The harder you work, the more confidence you get. But you may be working hard on something you're no good at. We're so afraid of that process that we don't do it.

How Do You Judge Managerial Talent: the Paper Record or Your Own Judgment? And How Did You Judge Eitan Wertheimer?

The paper record is usually a better indicator of talent . The paper record of this man is so extraordinary that it couldn't have been created by an ordinary human being. If you

add to that the man's obvious character and intelligence – who isn't looking for that? You also want to get a fair price of course.

Eitan said he learned some things from us. He's one of the smartest men I've met in my whole life. I can't imagine he'd learn anything from me.

When You Bought Iscar, Did You Consider That One of Israel's Greatest Companies Is No Longer Israeli Owned and Controlled?

You gotta understand that these people picked us. All we did was say yes. [Laughter] We think the kind of people who seek us out have such marvelous judgment that they're the kind of people we want to be in business with.

Details on Iscar

That was a very intelligent question and I'm going to give you a very intelligent answer: I'm not going to answer. [Laughter] All I'm going to say is that we are very happy with the acquisition and the price we paid. It's not rudeness. We want Iscar to be run like it has been in the past. They want to be private and quiet and we have a tradition of respecting this.

Do You Have Difficulty Reading Financial Statements of Foreign Companies?

We've been looking at financial statements for a long time. We feel, in some cases anyway, that we know what a foreign financial statement is telling us. Generally, would we would we feel more confident in our own currencies, etc.? Yes. But we feel that we can understand them [foreign financial statements].

Difficulty Investing in a Foreign Culture

Of course it's more complicated to make a decision in a foreign culture. But I think you can discern a great business in a foreign culture. [But you have to be careful.] I was amused when the dictator of Indonesia said, "What look like embezzlement to you people looks like Asian family values to us." [Laughter]

Why Doesn't Berkshire Just Buy 100% of Wesco?

It's complicated. You people, because you like the value system, have bid the price of Wesco above the liquidating value of the business, so we can't merge it into Berkshire. There are a lot of irritating conflicts. But I like you and I don't feel guilty because you can always sell your stock for more than [Wesco's] liquidation [value]. It has its disadvantages [but they're not insurmountable].

Comments on Berkshire's Float

We love having the float at Berkshire. If we didn't have it, Berkshire would be worth less than it is. It will grow more slowly in the future. There isn't that much float in the world [for Berkshire to continue growing it at such a high rate] – it's not a huge market. Float's very desirable thing. We don't think it's a model that will help you in other investment opportunities.

Why Haven't You Invested More in Foreign Stocks?

We've light on foreign stocks for our entire history, but we were still able to get the company [Berkshire] from $10 million [in stock market value] to over $100 billion, so there were worse tragedies that we missed foreign stocks. I don't know a lot about foreign stocks. I do think that there have been opportunities in some foreign countries that if we'd looked at them closely we would have wanted to invest. But every one that I can think of that looked intriguing was way to small to be of interest for Berkshire – they weren't the great big ones.

Overall, I don't have many regrets here – I think the United States has been a better place to be than, say, England for the past 30 years.

Buffett's Decision to Sell the South Korean Stocks He Bought

Warren's entitled to do whatever he wants with the sell decisions. Anyway, he was more interested in finding an inefficient market than he was in making the money. [Laughter]

Why Didn't You Invest in K-Mart or Tyco?

I didn't think about K-Mart. As for Tyco, I thought about and I passed, but I don't want to tell you the reason.

Impact of Lead Paint Liability?

Berkshire has one subsidiary, Benjamin Moore, that's been making paint for a long, long time. But it's a tiny part of Berkshire and my guess is that this issue is not meaningful.

The Morality of Investing in PetroChina, Which Is Helping the Government of Sudan, Which is Behind the Genocide in Darfur

You've raised a subject about which I know absolutely nothing. But all major oil companies that work in the Third World run into the problem of having to work with governments that are doing bad things. This is a classic problem.

I think it would be very hard to invest in oil at all without encountering some of these issues. Under those circumstances, what do you do if you're the company? Not go in? Or if you're already in, pull out?

I don't think, by and large, that passive shareholders of companies need to have fits if a company they're invested in is doing something somewhere that you and I wouldn't approve of.

USG

USG of course was a great success story. It benefited greatly from the great construction boom, and it worked out deal to deal with its asbestos agony. They now have a plan to exit bankruptcy. I think management has done a hell of a job.

Do You Think One Has Lived a Better Life If One Builds Wealth By Owning Businesses Rather Than Buying Stocks?

The answer is HELL YES! If all you do is make yourself rich through buying passive stakes, [you haven't lived much of a life]. Making your way as a professional poker player in Las Vegas – it pays the bills but is not a great moral beacon.

Obviously we think the pattern and life [of owning businesses] is better. Gin rummy behavior [of rapidly swapping] colleagues and businesses changing. No one admires that with wives and many of us spend more time with our businesses than wives. So constantly changing businesses [is nuts]. I don't consider this as good a life as the one we're living. Maybe [our behavior] is just serving our personal idiosyncrasies, but I say we're entitled. [Laughter]

But You Sold US Airways

Yes, but US Airways was not a subsidiary. We had some representation on the board, but did not control it. [That being said,] had we controlled it, we still would have sold it. It was out of control. But the sales we've made over the years are tiny and few.

Macro- and Micro-economic Considerations When Buying Companies

We simply try buy things for less than they're worth. We're not making microeconomic decisions or forecasts. We predict they [the companies we buy] will swim better, but we're not betting on the tide.

If we found a good business tomorrow, we'd buy it. We've been doing that all along. I'm not good at predicting macro things.

Since Size Hinders High Investment Returns, Why Don't You Focus on Managing Your Own Assets, Rather Than Berkshire Hathaway's?

Since my own assets are in Berkshire, so I don't have much choice, do I? [Laughter]

Is Your Salary of only $100,000 Per Year Fair?

Yeah, it's fair. I like to think that it's more than fair, but what the hell. [Laughter]

Berkshire's Influence as a Role Model

[The questioner addressed him as "Mr. Buffett," to which Munger replied, "My name is Munger. [Laughter]]

Obviously, with the annual meetings and writing what we write, we're trying to have some influence on other people. But in terms on changing other people, I think the influence is tiny. It's very hard to change people when the incentives are in the opposite direction. I know many people who've bought lots of copies of Poor Charlie's Almanack and given it to their children and grandchildren in the hope of influencing them [but I don't think it's had much impact]. If that worked, there'd be a line from here to Denver [to attend the Wesco meeting]. [Laughter]

ADVICE ON INVESTING

Lessons from Losing Money in the Munger Partnership in 1973-74

That is a very good question. When I operated a partnership, I got hit in 1973 and 1974, which was the worst collapse since the 1930s. So I got hit with a once-in-50-years-type event. It didn't bother me with my own money, but it made me suffer the tortures of hell as I thought through the loss of morale of the limited partners who had trusted me. And the agony was compounded because I knew that these assets were sure to rise because they could be liquidated for more than I'd bought them for in due course. But the individual securities were traded in liquid markets so I couldn't mark them up from the trading price because the opportunity cost for my partners was set by the trading price. I would say that was pure agony. The lesson from that for all of you is that you can have your period of pure agony and live through is for many decades. It's a test of character an endurance.

I don't think any fully engaged young man wouldn't have gotten into the pain that I did in 73-74. If you weren't aggressive enough and buying on the way down and having some agony at the bottom, then you weren't living a proper investment life. I wouldn't quarrel with anyone who was more cautious and less aggressive than I was. But what got me into the agony was buying things for far less than what I was sure I could liquidate them for in due course. I don't think it was wrong, but it was agony.

More Comments on Activist Investors

Enormous blocks of stocks are held by employee pension plans with an ax to grind. Other groups of activists [have their own agendas]. It would be nice if the people who would be natural activists would be the type of people we'd want [to act on behalf of all

shareholders, but they're not]. I think the world is better when the Predators' Ball days waned. Generally speaking, shareholder activism is naturally going to be done by a group that many of you won't admire.

Lamenting Best Minds Going Into Hedge Funds

Somehow we've created a perverse system of incentives. At Samsung, their meeting of engineers is at 11pm. Our meetings of engineers [meaning our smartest citizens] are also at 11pm, but they're working to price derivatives. I think it's crazy to have incentives that drive your most intelligent people into a very sophisticated gaming system.

A rich system can endure a lot. If 10% of our people over age 60 want to spend X hours per week playing Texas Hold Em, we can afford it. But it's not good. But do we want our auto industry to just crumble away and somebody else's to take over because they do it better? I don't think it's a good outcome. I don't think we can stand a diversion of our best minds to hedge funds.

How to Pick a Good Money Manager

There are a lot of honorable people out there and a lot of charlatans. If you don't have expertise in the field, it's hard to do – I don't have a one-sentence formula for doing that. I always prefer a system in which people are eating their own cooking, so look for a money manager who has almost all of his net worth alongside yours in his fund. This was Warren Buffett's rule when he ran the Buffett Partnership. Another rule is to avoid things with a high commission: avoid *anything* sold by *anyone* on a high commission!

Thoughts on Value Investing

Some people come to our annual meetings to figure out how to many money. We've always believed in value investing – just try to get more value than you're paying for. There are a lot of ways to do this – it could even be investing in another manager. Or you could invest and hold for 30 years.

But nobody could make a living if that's all they practiced. You need some mumbo jumbo if you're going to be a witch doctor. You need some song and dance. [Laughter]

Investor Irrationality

Copper stays low for decades and we finally get a shortage of it, and all of a sudden it's in the stratosphere. I've seen housing prices collapse when the population is leaping. Once prices start galloping, people buy real estate like they buy stocks in Saudi Arabia or Kuwait – because they're doing up. A whole class of day traders became condo flippers. It really happens – thousands of them.

But you always have stock markets where prices stay low for long time. This is good for people like you. This is why you can afford to fly long distances to come to Pasadena [to hear me and learn about value investing].

Learn at the Temple of Rationality

All you have to do is keep trying to learn at the temple of rationality and do things [when it makes sense]. I'm quite prosperous even though I didn't invest in K-Mart's bankruptcy. You can miss a lot. We bought 4% of Freddie Mac [many years ago] yet none of Fannie Mae. How could the same mind have done that?! It wasn't very smart.

But despite the many cognitive mistakes [we've made], we're a lot richer now than we were then. I think you need to constantly remember the mistakes of omission. We're very good at this. Nobody remembers them – nobody thinks less of me for missing K-Mart – but I think about it every day. It's a very [useful discipline to have].

Chris Davis [of Davis Advisors], who's not here, has a temple of shame for mistakes. [It's a wall in his office in which he hangs stock certificates of the worst stocks he's ever invested in.] But this is inadequate. You need the temple of shame squared – great things you almost did and, had you been a little more rational, should have invested in. You'll be a lot better investor if you do this. You ought to remember boners of both kinds. Reality doesn't distinguish – either way, in 10 years, you're poorer. So why not celebrate your mistakes in both categories?

Efficient Market Theory

We didn't get any courses [on value investing] into [the curriculums of] major universities for the first 30 years [in which investing was taught], but it's shifted a bit in the past 10 years. The flat earth people [meaning the believers in the Efficient Market Theory] are only now about 75-80% [of the faculties].

RISKS IN THE FINANCIAL SYSTEM

Derivatives and Accountants Selling Out

This world of derivatives is another place the world has gone absolutely bonkers by the standards of the past. You take Fannie Mae – a big, clumsy, dumb bureaucracy to start with – and they're in this great privileged position where they got enough of a government halo so that their borrowing costs were lower than other people's. And they created this marvelous intermediary system where they were able to take an override on the safe mortgages of the world. They could raise earnings 20% per annum for a decade or so, but that wasn't enough. They wanted to make sure that they earned 15-20% every quarter than they earned in the previous year's quarter. And so they listen to the siren song of the professionals who invented these mad derivatives. And of course there was a lot of leverage in the bargain.

When they tried to clean up Fannie Mae, the new CEO complained that spent hundreds of millions of dollars on experts just trying to understand what's already on the books. You get people investing weird things, complex things for other people to gamble in. And those silver-tongued salesmen going into leading institutions, with wonderful slide shows showing how everything's going to work way better for them – weird things get done. What happens, of course, is that the same derivative trade that's put on, the accountant for Firm A says that the firm made $8 million, and the accounting firm for firm B says its client *also* made $8 million, and it's the same trade. I've never met anyone in the accounting profession that's bothered by this. They go around and *check* to see if the retailer owes some money to a wholesaler – they want to make sure that it's the same on both sides. But on derivatives, the accounting profession has sort of given up – it gets complicated. I don't think given up is the right word: They sold out. You'd think they'd learn by now and put more integrity into the system. But telling people to do something unpleasant when they're making a lot of money out of it…it's too hard. I likened it in some previous discussion to what doctors have to do when someone's on life support. The religions of the world say it's perfectly alright to withdraw the tubes – you can withdraw artificial help. But when you do it and the patient shrivels up like a prune, the guy who pulls the tube out feels like a murderer. He's not – it's the correct thing – but that's what he feels like. I think that's the way the accountants react to the situation when $8 million of profit is being booked by each side of the same trade. He can't pull this plug. He doesn't want to think about the consequences.

Maybe there's some more kindly explanation. [Laughter] I'll give our accountant [who was sitting on the stage next to Munger] the opportunity if he wishes to participate in this discussion and explain why the accountants are doing what they're doing. [Short pause] He says he has nothing to add. [Laughter. (That's Munger's oft-repeated line from the Berkshire Hathaway annual meeting.)]

More on the Risk of Derivatives

I regard the counterparty risk as extreme. But no-one cares about this because the accounting statements assume it away. If you look at the trading sheets on Wall Street, there's no line for counterparty risk. The person who is supposed to think about this would be very unpopular [if he tried to add this]. Pulling away the punch bowl at the party has never been a way to prosperity and popularity.

If you look at derivative markets enough, you think it was scandalous. That doesn't mean it can't go on for along time, however. Look at Japan. Great civilizations can withstand a lot of terrible behavior. It's a good thing. Lord knows, we'll need it.

Look at Berkshire's Gen Re derivative book. It was valued at $400 million on the balance sheet [but when he reached for the money, it wasn't there]. Imagine an balance sheet item labeled: "Asset – good until reached for"! [Laughter] [My comment: In fact, Berkshire has taken hundreds of millions of dollars in losses as it's run off this derivatives book – during a benign time in the markets, when no-one else was trying to

run off their book! Can you imagine the utter chaos that would ensue if, say, JP Morgan Chase tried to run off its $40+ *trillion* derivatives book?!]

Final Comments on Derivatives

If we have a hell of a mess due to a big derivatives blowup, the country will survive it. Did we need derivatives to get to their current huge size? [Of course not.] [People argue that because] it lays off risk, it therefore it must be wonderful. That is not the Munger mindset. If you're lucky, we'll see who's right.

Danger of Ballooning Consumer Debt

There's no question that huge ballooning credit practices in other places have caused crashes. For example, South Korea had a huge crash from irrationally ballooning consumer credit. But I can't predict whether the troubles I foresee will come soon or later. All I can predict is that there is considerable danger.

Risk of a Hedge Fund Blowup

There will be some repeat of Long Term Capital Management in some place – you can count on that. There's a lot of real brainpower at a lot of these firms and some are making a lot of money by being very shrewd. The problem is envy and imitation. The result will be like what happened with early stage venture capital in Silicon Valley. Envy will lead to a flood of money and then a disaster.

Should One Be Worried About Having Cash in a Brokerage Account?

I think a cash account at the really strong brokerages is safe enough. You have other better things to worry about. As for margin accounts, with hedge funds using leverage, there will be troubles there. You'll notice there's an uproar at Refco. You do not want to have a margin account at a dubious firm. And personally, I wouldn't want 100% of my assets in a brokerage account at even the strongest financial firm in America. Margin debt I'd be very goosy about right now.

How Fearful Should We Be About a Major Meltdown?

Every period is weird in its own way, but this period is extra weird. I could add the twin deficits to what I said earlier [about the things that worry me]. Yet economy is [rolling along]. I think it's almost always a mistake to think that a great civilize can't take some more [bad behavior]. I have friends who are building bomb shelters and the like [which is going overboard in my opinion]. I'm all for being reasonably cautious, like John Arrillaga [who Munger discussed in his opening remarks]. I haven't had any debt for a long, long time. Neither has Warren – not any significant debt anyway; maybe a blip.

But I think the rationality you're talking about is pretty sure to work. It won't save you from a terrible accident or the death of a child, but character and rationality will save you from a lot.

It's all about not trying to get the extra zero on your portfolio's total value when you die. It's playing the game all the way through with both character and rationality. It doesn't do any good to [have good motives?] if you're a horse's ass [?]. [Laughter]

COMMENTS ON BUSINESS AND ECONOMIC MATTERS

Backdating Stock Options

I think backdating stock options is embezzlement. I would argue that if it happened, it was criminal.

But I would bet that the people who did it think it was god's work. [They probably said to themselves:] "If options are great, then this must be even greater!" I'll bet there's no sense they did anything wrong. It's hard to believe that the human mind can play such ghastly tricks.

How to Change Corporate Directors' Behavior

The only thing that will change corporate directors' behavior is if they look ridiculous in the press. Otherwise the CEO could be an ax murderer. [Laughter]

Is Home Depot's CEO [Bob Nardelli] Being Paid Too Much in Light of the Company's Stock Decline Since He's Been CEO?

Generally I don't think management should be blamed if the stock market goes crazy for a certain period of time. If it went up 35 times earning and then declined to 25 times earnings, how is that the CEO's fault? Lou Simpson bought that stock and I don't think he'll want to comments on the situation at Home Depot. I'm not in a position to judge if the CEO's compensation is reasonable or not, but I wouldn't be surprised if it was.

Corporate Compensation

I don't know how we're going to fix corporate compensation. To have the CEO rewarded in a way that's so extreme [is terrible].

Future Oil Prices

I think eventually the price will be higher than it is now, but what will happen in the meantime I don't know. I'm not an expert on the price of oil, but I think it will get harder to extract hydrocarbons and demand for them will go up.

I think future generations will curse us for using hydrocarbons for our cars when they need them to grow food to eat.

Views on Naked Shorting

One of the nice things about being an old man in a secure place is that I don't have to think about many things and naked shorting is one of them. My jihad calendar is full enough. [Laughter] I'm sorry, that's all I have to say.

Book Recommendation: Fortune's Formula

I like that book that I recommended [a while ago] in which the guy that explained all of these weird guys at the horse races – a value investing thing with a lot of math in it. What was the name of it? Fortune's Formula. It's a very worthy book and you all ought to read it.

In Hong Kong, people are crazy about horse racing and everyone bets on the races, yet somebody was actually able to develop a lot of algorithms such that, in spite of the croupier's take, he was able to make a lot of money. Some of that is going on in a lot of these hedge funds. Some guy can develop a lot of algorithms and can outwit the other guys' algorithms. But it's not for me…

Comments on the Kelly Formula, Which Is Detailed in Fortune's Formula

[Munger had trouble hearing the question and asked the questioner to repeat it more slowly, saying, "Keep in mind you're dealing with a slow-witted old man."]

The first time I read that sizing system, my take is that it seemed plausible to me, but I haven't run that formula through my head – and I won't. You couldn't apply it to the investment operations I've run [I think because of Berkshire's size], but the gist of it in terms of sizing your bet makes sense. Whoever developed that formula has an approach to life similar to mine.

If you could flip a coin and get a 4-to-1 payoff [if you called it correctly], would you invest your house, your net worth, everything? I don't think so. You only get to live once.

[The person who asked the question answered, "Maybe" [Laughter]]

All I can say is that you remind me of a man who once worked for a contractor I knew. He was very bold and aggressive. The contractor said, "Old Charlie is going to become a millionaire – several times." [Laughter] I think we've identified another Old Charlie. But at least you're asking the right question and at least you said maybe.

Generally speaking, I'm closer to you when you said maybe, at least I was when I was your age.

Unrealistic Return Assumptions of Pension Funds

Both Warren and I have said that to predict 9% returns from those pension funds is likely to be wrong and it is irresponsible to allow it. They do it to delay bad news. Look at Berkshire and our paper record, which is obviously much better [than the investment track records of the pension fund managers]: we use 6.5%. For example, the Washington Post has the best record [of virtually any pension fund, yet it assumes a 6.5% annual return]. Do you want to believe the predictions of the people with the best record or do you want to believe the people who are acting in the way Demosthenes predicted when he said the wages of profit are [?]. In other words, what a man hopes is what he believes.

Housing Bubble

The weirdest things I see are in really good coastal properties. It can't keep bubbling up like it has been. But when and how it will collapse I don't know.

Housing Bubble and Likely Future Low Returns from Real Estate

Recently someone paid $800 per square foot for the air rights to build a piece of property in Manhattan. This is driven by the prospect of selling condos for high prices. The condo selling game has already crested in Las Vegas and Miami. In Los Angeles, I don't think it's quite crested, but certainly you're seeing weird prices.

I'm not sure it's crazy. In other words, if you have an apartment building, after costs of maintaining it, assuming no rent control ever, you might earn a 4.5% annual return [if you pay today's prices for it]. I'm not sure that that's crazy. It's not as good as the kind of stocks Berkshire would own, but it's not crazy. We may be in that kind of world [of low returns]. That's already happened in Europe where apartment buildings already have 3% yields. Stranger things have happened...

Interest Rates and Inflation

I have never believed that interest rates have a perfect correlation to inflation. I think there's some relation, but it's complex and not easily quantifiable.

Class Action Litigation

It doesn't affect Berkshire because we don't offer Directors & Officers coverage, though we do cover product liability. There's a lot of abusive litigation in the silicosis field. The asbestos lawyers just rewrote the same complaints. [It reminds me of the class action lawyer who, faced with a judge who wasn't friendly,] said, "By god, I'm getting tired of this harassment and by god I'm going to take my witnesses and go to Chicago!" [Laughter]

The behavior of the class action lawyers [who sue companies] may be quite inappropriate, but the behavior of the people in the corporations may be quite inappropriate as well.

Municipalities' Bad Accounting for Future Pension and Healthcare Liabilities

They've gotten very lucky thanks to the accountants. [My comment: Unlike corporations, which have to account for such liabilities on their balance sheet and in the footnotes to their financial statements – at least in part (there's massive abuse and understatements here) – a loophole in accounting rules has allowed cities and states across the country to make promises of pension and healthcare payments to municipal employees' unions totaling hundreds of billions of dollars in present value, yet this doesn't have to be disclosed or reserved for. The accounting loophole was recently closed and I predict there will be hell to pay as municipalities have to suddenly come up with this money.] If that [continued bad accounting] doesn't work, then they'll have to go to Plan B: increase taxes. I predict that whatever disgusts you in this field will continue for a long time.

Newspapers

I think their future is way worse than their past.

Dividend Payout Ratio of the S&P 500

I don't really have a big opinion on the dividend payout ratio of the S&P. To me, it's within hailing distance with being reasonable…That's all I have to say. [Laughter]

ADVICE ON LIFE AND OTHER

The Importance of Being an Exemplar

I think people have a duty when they rise high in life to be exemplars. A guy who rises high in the Army or becomes a Supreme Court justice is expected to be an exemplar, so why shouldn't a guy who rises high in a big corporation act as an exemplar and *not* take every last penny?

It's not a problem we've had at Berkshire, but look at how far it's spread. We have about two imitators. [Laughter]

The Future of American Civilization

I've said that American society is *near* its apex. It could be just before or just ahead of that point. Other people are more optimistic; Warren is more optimistic than I am. We've had the most incredible generations. Do you think it can go from generation to generation, from apex to apex? The historical record would give you some caution.

Whether the good behavior and values will outweigh the bad, I don't know. On my way over here, I stopped to watch the concrete being poured for a new Wesco building. The design is sound. The system for putting it together is sound. The skill of the crews is sound. The inspection process is sound – every single pour of concrete is watched by an inspector paid by the city of Pasadena, and he's a good, competent man. He watches to make sure every bar of rebar is correct. This building will outlast the pyramids. This system is a credit to our civilization. In contrast, look at the same process in Latin America or Japan, where guys take bribes.

There is a lot that is right in our country. In a recent five-year period, not one passenger died on a major airline. Imagine if other engineering systems were as good. A lot of pilots are recovering alcoholics, yet the system is safe enough to get us around this.

United States Fiscal and Trade Deficits

Regarding currency and oil – this is a very sophisticated crowd [laughter]… Regarding currency, the United States is very peculiar running such a large trade deficit and a fairly big fiscal deficit. [I couldn't hear his remarks for a few sentences here.] The absurdity of this kind of thing…I'd rather not run such a big fiscal and trade deficit. If we have a war, I'd rather add a blank space on tax returns, asking people to pay 10% more for a national emergency. It wouldn't be compulsory, but if you don't pay, we'll publish your name. [Laughter] I'd be in favor of that kind of stuff. Maybe I'd [be great?] for the United Jewish Appeal [an extremely successful fundraising organization, in part because it's very public about who makes big donations – and if you're a wealthy Jew, you're shamed if you're not on the list].

But my ideas aren't winning. They're odd, of course. I'm not predicting ruin, but I think it would be more conservative to behave differently.

China's Growth and Future Pollution

China's vast growth of GNP of 9-10% per annum is a remarkable thing. I think the government will be smart enough to let the tiger grow and then there will be a big pollution problem – and the United States will be way less important relative to other nations than it is now.

Best-Loved Ideas That He's Destroyed Recently

[In last year's annual meeting, Munger talked about the importance of destroying at least one of your best-loved ideas each year, so a shareholder asked which of his best-loved ideas he's destroyed in the past year.]

I had more scorn for fixed income arbitrage in the past than I do now. I was also more hopeful about troubles in the Middle East than I am now. So I've destroyed some of my optimism in favor of more realism. I don't think there's a man or woman in the room

that thinks they have a better grasp of what going on in the Middle East [now than they did previously]. Doesn't matter what you think of this administration.

The ability to destroy your ideas rapidly instead of slowly when the occasion is right is one of the most valuable things. You have to work hard on it. Ask yourself what are the arguments on the other side. It's bad to have an opinion you're proud of if you can't state the arguments for the other side better than your opponents. This is a great mental discipline.

Reflections on Looking Back at His Life

I wouldn't have done a lot in my life different. I think I've been a very fortunate man and I don't think I should be complaining about how my life has worked out.

The other day, I was looking back at Berkshire over the past 10 years, since it was recently the 10-year anniversary of the Berkshire B shares. Sure, the rate of growth has come down, but we have added *a lot* of value and that's with a tough strategy the past few years. So generally speaking, I have no regrets.

The only regret I have it that I'll soon be dead. [Nervous laughter] I deal with it through humor. Some people deal with it through religion; I deal with it through humor.

[My comment: Munger has in the past spoken many times about the reality that he won't live forever, usually in a light-hearted way, but this was the first time I felt he was really serious. It was a poignant moment, as a great man shared with his wife (Nancy, who was in the front row), family, friends and most ardent admirers his sorrow that he sees the end of his road approaching. That being said, his mind is as sharp as ever and he clearly relishes his life, so I think he's got quite a few good years left!]

WESCO FINANCIAL CORPORATION

Annual Report 2006

Form 10-K Annual Report 2006

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated net ''operating'' income (i.e., before realized investment gains shown in the table below) for the calendar year 2006 increased to $92,033,000 ($12.93 per share) from $77,973,000 ($10.95 per share) in the previous year.

Consolidated net income decreased, from $294,579,000 ($41.37 per share) in 2005, to $92,033,000 ($12.93 per share) in the current year.

Wesco has four major subsidiaries: (1) Wesco-Financial Insurance Company (''Wes-FIC''), headquartered in Omaha and engaged principally in the reinsurance business, (2) The Kansas Bankers Surety Company (''Kansas Bankers''), owned by Wes-FIC and specializing in insurance products tailored to midwestern banks, (3) CORT Business Services Corporation (''CORT''), headquartered in Fairfax, Virginia and engaged principally in the furniture rental business, and (4) Precision Steel Warehouse, Inc. (''Precision Steel''), headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses.

Consolidated net income for the two years just ended breaks down as follows (in thousands except for per-share amounts)[1]:

	Year Ended			
	December 31, 2006		December 31, 2005	
	Amount	Per Wesco Share[2]	Amount	Per Wesco Share[2]
Operating earnings:				
Wesco-Financial and Kansas Bankers insurance businesses —				
Underwriting	$ 5,164	$ .73	$ 11,798	$ 1.66
Investment income	58,528	8.22	39,068	5.49
CORT furniture rental business	26,884	3.78	20,676	2.90
Precision Steel businesses	1,211	.17	1,198	.17
All other ''normal'' net operating earnings[3]	246	.03	5,233	.73
	92,033	12.93	77,973	10.95
Realized investment gains[4]	—	—	216,606	30.42
Wesco consolidated net income	$92,033	$12.93	$294,579	$41.37

(1) All figures are net of income taxes.

(2) Per-share data are based on 7,119,807 shares outstanding. Wesco has no dilutive capital stock equivalents.

(3) Represents income from ownership of the Wesco headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the insurance subsidiaries, less interest and other corporate expenses.

(4) Includes $216,112,000 ($30.35 per share) from the tax-free exchange of Wesco's common shares in The Gillette Company for common shares in The Procter & Gamble Company in connection with the merger of Gillette with Procter & Gamble. Although no cash was received, generally accepted accounting principles required that the gain be recorded. Because Wesco's balance sheet reflects investments carried at market value, with unrealized gains, after applicable income tax effect, included in shareholders' equity, the transaction did not affect Wesco's shareholders' equity. It merely resulted in a reclassification from unrealized gains to retained earnings, another component of shareholders' equity.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The foregoing

supplementary breakdown is furnished because it is considered useful to shareholders. The total consolidated net income shown above is, of course, identical to the total in our audited financial statements.

Insurance Businesses

Consolidated operating earnings from insurance businesses represent the combination of the results of their insurance underwriting (premiums earned, less insurance losses, loss adjustment expenses and underwriting expenses) with their investment income. Following is a summary of these figures as they pertain to all insurance operations (in 000s).

	Year Ended December 31,	
	2006	2005
Premiums written	$55,510	$50,253
Premiums earned	$54,149	$49,482
Underwriting gain	$ 7,944	$14,566
Dividend and interest income	83,441	55,889
Income before income taxes	91,385	70,455
Income taxes	27,693	19,589
Total operating income — insurance businesses	$63,692	$50,866

Following is a breakdown of premiums written (in 000s):

	2006	2005
Wes-FIC —		
Aviation pools	$35,714	$29,118
Other	(4)	(64)
Kansas Bankers	19,800	21,199
Premiums written	$55,510	$50,253

Following is a breakdown of premiums earned (in 000s):

	2006	2005
Wes-FIC —		
Aviation pools	$33,326	$28,391
Other	(3)	(53)
Kansas Bankers	20,826	21,144
Premiums earned	$54,149	$49,482

Following is a breakdown of after-tax results (in 000s):

	2006	2005
Underwriting gain —		
Wes-FIC	$ 1,650	$ 6,787
Kansas Bankers	3,514	5,011
	5,164	11,798
Net investment income —		
Wes-FIC	53,732	36,032
Kansas Bankers	4,796	3,036
	58,528	39,068
Total operating income — insurance businesses	$63,692	$50,866

As shown above, operating income includes significant net investment income, representing dividends and interest earned from marketable securities. However,

operating income excludes investment gains of $216.6 million, net of income taxes, realized in 2005. No investment gains or losses were realized in 2006. The discussion below will concentrate on insurance underwriting, not on the results from investments.

Wes-FIC engages in the reinsurance business. For the past several years, its reinsurance activity has consisted of the participation in several risk pools managed by an insurance subsidiary of Berkshire Hathaway, our 80%-owning parent. The arrangement became effective in 2001 and most recently covered hull, liability and workers' compensation exposures relating to the aviation industry, as follows: for 2005, to the extent of 10% in the hull and liability pools and 5% of a workers' compensation pool; for 2006, 12½% of the hull and liability pools and 5% of the workers' compensation pool. For 2007, participation in the hull and liability pools has increased to 16.67%. The Berkshire subsidiary provides a portion of the upper-level reinsurance protection to these aviation risk pools on terms that could result in the Berkshire subsidiary having a different interest from that of Wes-FIC under certain conditions, e.g., in settling a large loss.

Wes-FIC's underwriting results have fluctuated from year to year, but have been satisfactory. When stated as a percentage, the sum of insurance losses, loss adjustment expenses and underwriting expenses, divided by premiums, gives the combined ratio. The combined ratios of Wes-FIC have been much better than average for insurers. Wes-FIC's combined ratios were 94.0% for 2006 and 75.9% for 2005. We try to create some underwriting gain as results are averaged out over many years. We expect this to become increasingly difficult.

Kansas Bankers was purchased by Wes-FIC in 1996 for approximately $80 million in cash. Its tangible net worth now exceeds its acquisition price, and it has been a very satisfactory acquisition, reflecting the sound management of President Don Towle and his team.

Kansas Bankers was chartered in 1909 to underwrite deposit insurance for Kansas banks. Its offices are in Topeka, Kansas. Over the years its service has continued to adapt to the changing needs of the banking industry. Today its customer base, consisting mostly of small- and medium-sized community banks, is spread throughout 30 mainly midwestern states. In addition to bank deposit guaranty bonds which insure deposits in excess of FDIC coverage, KBS offers directors and officers indemnity policies, bank employment practices policies, bank insurance agents professional errors and omissions indemnity policies and Internet banking catastrophe theft insurance.

When Wesco purchased KBS, it had been ceding almost half of its premium volume to reinsurers. Now it reinsures only about 14%. Effective in 2006, insurance subsidiaries of Berkshire Hathaway became KBS's sole reinsurers. Previously, an unaffiliated reinsurer was also involved. The increased volume of business retained comes, of course, with increased irregularity in the income stream. KBS's combined ratios were 73.8% for 2006 and 58.8% for 2005. We continue to expect volatile but favorable long-term effects from increased insurance retained.

CORT Business Services Corporation ("CORT")

In February 2000, Wesco purchased CORT Business Services Corporation ("CORT") for $386 million in cash.

CORT is a very long-established company that is the country's leader in rentals of furniture that lessees have no intention of buying. In the trade, people call CORT's activity ''rent-to-rent'' to distinguish it from ''lease-to-purchase'' businesses that are, in essence, installment sellers of furniture.

However, just as Enterprise, as a rent-to-rent auto lessor in short-term arrangements, must be skilled in selling used cars, CORT must be and is skilled in selling used furniture.

CORT's revenues totaled $400 million for calendar 2006, versus $384 million for calendar 2005. Of these amounts, furniture rental revenues were $324 million and $304 million, furniture sales revenues were $70 million and $72 million, and apartment locator fees of its relocation division were $6 million and $8 million. CORT operated at an after-tax profit of $26.9 million for 2006, up satisfactorily from its $20.7 million of after-tax profit for 2005 (versus $5.0 million for 2004). These results reflect the favorable effects of several ''tuck-in'' acquisitions made between the years 2001 and 2004.

When we purchased CORT early in 2000, its furniture rental business was rapidly growing, reflecting the strong U.S. economy, phenomenal business expansion and explosive growth of IPOs and the high-tech sector.

Beginning late in 2000, however, new business coming into CORT began to decline. With the burst of the dot-com bubble, the events of September 11, and a protracted slowdown in new business formation, CORT's operations were hammered, reflecting generally bad results in the ''rent-to-rent'' segment of the furniture rental business. Obviously, when we purchased CORT we were poor predictors of near-term industry-wide prospects of the ''rent-to-rent'' sector of the furniture business.

CORT started up a new service during 2001. Originally a subsidiary named Relocation Central, and now its CORTline division, it was conceived mainly to supplement CORT's furniture rental business by providing apartment locator and ancillary services to relocating individuals. Long CORT's star CEO, Paul Arnold is in process of expanding CORTline's operations and redirecting its marketing, with the expectation that it will become a financial success. CORTline, originally conceived to assist relocating individuals, has recently expanded its services and capabilities and has begun to market itself toward the needs of businesses and governmental agencies who require a skilled and able partner to provide the full gamut of seamless relocation services for the temporary relocation of employees. With several websites, principally, www.cortline.com, www.relocationcentral.com and www.apartmentsearch.com, professionals in more than 80 domestic metropolitan markets, affiliates in more than 50 countries, almost twenty thousand apartment communities referring their tenants to CORT, many ancillary services, and its entrée to the business community as a Berkshire Hathaway company, CORTline now seems to be moving in the right direction.

We are pleased with the progress CORT made in the past two years. We are cautiously optimistic that, in future years, we will be able to look back to the recent past and consider it merely a cyclical aberration in CORT's growth. We note, however, that the number of furniture leases outstanding has been slightly declining in each of the past two years.

When Wesco paid $386 million for CORT, about 60% of the purchase price was attributable to goodwill, an intangible balance sheet asset. Wesco's consolidated balance sheet now contains about $267 million in goodwill (including $27 million from Wesco's 1996 purchase of KBS). The Financial Accounting Standards Board adopted a rule which became effective in 2002 that no longer requires automatic amortization of acquired goodwill. (The requirement for such amortization has been replaced by a standard that requires an annual assessment to determine whether the value of goodwill has been impaired, in which event the intangible asset would be written down or written off, as appropriate.) Earnings, not reduced by goodwill amortization, that we have reported since 2002 more closely reflect microeconomic reality as we appraise it.

More details with respect to CORT are contained throughout this annual report, to which your careful attention is directed.

Precision Steel Warehouse, Inc. ("Precision Steel")

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, operated at after-tax profits of $1.2 million in both 2006 and 2005. These figures reflect after-tax LIFO inventory accounting adjustments decreasing after-tax income by $.6 million for 2006 and $.2 million for 2005. Precision Steel's operating results for 2006 also reflect expenses, net of insurance recoveries, of $.3 million, after taxes, in connection with environmental cleanup of an industrial park where a Precision Steel subsidiary has operated alongside approximately 15 other manufacturers for many years. Had it not been for the LIFO accounting adjustments or the environmental matter, Precision Steel would have reported after-tax operating income of $2.1 million for 2006 and $1.4 million for 2005.

Precision Steel's business has been subject to economic cycles. Although the fiercely competitive, chaotic pressures affecting its steel service center business (which we described at length in last year's shareholders' letter) have recently abated, Precision Steel is continuing to suffer the ongoing effects of a long-term reduction in demand caused by customers' (or former customers') unsuccessful competition with manufacturers outside the United States. Precision Steel's revenues increased 2.8% in 2006, approximately half of which was due to an extraordinary order of shimstock and other industrial supplies from a customer of its Precision Brand Products subsidiary. Revenues for 2005 increased by 1.4% from those of 2004. In 2006, Precision Steel's service center volume was 46 million pounds, down from 69 million pounds sold as recently as 1999. This decline in physical volume is a serious reverse, not likely to disappear in some "bounce back" effect. Nor do we expect another sharp rise in prices like the approximately 40% rise that recently occurred, holding dollar volume roughly level despite a precipitous drop in physical volume.

Although Precision Steel's recent after-tax operating earnings of approximately $1 million per year may signal improvement when compared with its after-tax operating loss of $.9 million for 2003, we do not consider present operating results to be a satisfactory investment outcome. Recent earnings of Precision Steel compare unfavorably with operating earnings which averaged $2.3 million, after taxes, for the years 1998 through 2000. Because the steel warehouse business may revert to even more difficult conditions, more decline for Precision Steel may lie ahead.

Terry Piper, who became Precision Steel's President and Chief Executive Officer in 1999, has done an outstanding job in leading Precision Steel through very difficult years. But he has no magic wand with which to compensate for competitive losses among his best customers.

Tag Ends from Savings and Loan Days

All that now remains outside Wes-FIC but within Wesco as a consequence of Wesco's former involvement with Mutual Savings, Wesco's long-held savings and loan subsidiary, is a small real estate subsidiary, MS Property Company, that holds tag ends of appreciated real estate assets consisting mainly of the nine-story commercial office building in downtown Pasadena, where Wesco is headquartered. Adjacent to that building is a parcel of land on which we are building a multi-story luxury condominium building. We are also seeking city approval of our plans to build another multi-story luxury condominium building on a vacant parcel of land in the next block. For more information, if you want a very-high-end condominium, simply phone Bob Sahm (626-585-6700). MS Property Company's results of operations, immaterial versus Wesco's present size, are included in the breakdown of earnings on page 1 within ''other operating earnings.''

Other Operating Earnings

Other operating earnings, net of interest paid and general corporate expenses, amounted to $.2 million in 2006, versus $5.2 million in 2005. Had it not been for favorable income tax adjustments of $4.9 million recorded in 2005, other operating earnings would have been $.3 million in 2005. The sources of the $.2 million of other operating earnings in 2006 were (1) rents ($3.7 million gross in 2006) principally from Wesco's Pasadena office property (leased almost entirely to outsiders, including Citibank as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiaries, less (3) general corporate expenses plus minor expenses involving tag-end real estate.

Realized Investment Gains

There were no realized investment gains in 2006. Wesco's 2005 earnings contained investment gains of $216.6 million, after income taxes. Only $.5 million was realized through the *sale* of investments; the balance, $216.1 million, resulted from the tax-free exchange of common shares of The Gillette Company (''Gillette'') owned by Wesco, for common shares of The Procter & Gamble Company (''PG'') in the fourth quarter of 2005 in connection with the merger of Gillette with PG. Accounting standards promulgated by the Financial Accounting Standards Board require that the fair (market) value of shares received in such an exchange be recorded as the new cost basis as of the date of the exchange, with the difference between the new basis and the historical cost realized in the audited financial statements as an investment gain. For tax return purposes, the securities acquired were recorded at the original cost of the securities exchanged. Thus, no income tax was due or paid.

Although the realized gain had a material impact on Wesco's reported 2005 earnings, *it had no impact on Wesco's shareholders' equity.* Wesco carries its investments at fair value, with unrealized appreciation, after income tax effect, included as a separate component of shareholders' equity, and related taxes included

in income taxes payable, on its consolidated balance sheet. Thus, the entire after-tax gain on the non-cash merger had been reflected in the unrealized gain component of Wesco's shareholders' equity as of September 30, 2005. That amount was merely switched from unrealized gain to retained earnings, another component of shareholders' equity. This accounting entry had no economic effect on Wesco, and you should ignore it when you are evaluating Wesco's 2005 earnings.

Consolidated Balance Sheet and Related Discussion

As indicated in the accompanying financial statements, Wesco's net worth, as accountants compute it under their conventions, increased to $2.40 billion ($337 per Wesco share) at yearend 2006 from $2.23 billion ($313 per Wesco share) at yearend 2005. The main causes of the increase were appreciation in fair value of investments, and net operating income after deduction of dividends paid to shareholders.

The foregoing $337-per-share book value approximates liquidation value assuming that all Wesco's non-security assets would liquidate, after taxes, at book value.

Of course, so long as Wesco does not liquidate, and does not sell any appreciated securities, including the PG shares Wesco received in connection with PG's acquisition of Gillette in 2005, discussed above in the section, ''Realized Investment Gains,'' Wesco has, in effect, an interest-free ''loan'' from the government equal to its deferred income taxes, subtracted in determining its net worth. This interest-free ''loan'' from the government is at this moment working for Wesco shareholders and amounted to about $42 per Wesco share at yearend 2006.

However, some day, parts of the interest-free ''loan'' may be removed as securities are sold. Therefore, Wesco's shareholders have no perpetual advantage creating value for them of $42 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than $42 per Wesco share.

Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway. Moreover, the quality disparity in book value's intrinsic merits has, in recent years, continued to widen in favor of Berkshire Hathaway.

All that said, we make no attempt to appraise relative attractiveness for investment of Wesco versus Berkshire Hathaway stock at present stock-market quotations.

Wesco's consolidated balance sheet reflects total assets of $3.0 billion as of yearend 2006. Of that amount, more than $1 billion has been invested in cash equivalents and fixed-maturity investments since early in 2003. Unless those funds can be attractively reinvested in acquisitions, equity securities or other long-term instruments of the type that helped cause the long-term growth of Wesco's shareholders' equity, future returns on shareholders' equity will probably be less than those of the past. Due to the current size of Wesco and its parent, Berkshire Hathaway, Wesco's opportunities for growing shareholders' equity are unlikely to be as attractive as in the past.

Wesco's shares were listed for many years on both the American Stock Exchange and, since 1963, on a regional exchange previously known as the Pacific Stock Exchange. Following the recent merger of various regional exchanges into the NYSE, the Pacific Exchange became the NYSE Arca exchange. We had happily paid a minimal annual listing fee of $1,000 for the privilege of having our shares listed on the Pacific Exchange. When notified last December that NYSE Arca had decided to increase Wesco's annual listing fee to $30,000, Wesco voted with its feet. Its shares are now listed only on the American Exchange.

The Board of Directors recently increased Wesco's regular dividend from 36½ cents per share to 37½ cents per share, payable March 8, 2007, to shareholders of record as of the close of business on February 1, 2007.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Shareholders can access much Wesco information, including printed annual reports, earnings releases, SEC filings, and the websites of Wesco's subsidiaries and parent, Berkshire Hathaway, from Wesco's website: www.wescofinancial.com.

Charles T. Munger
Chairman of the Board
and President

February 27, 2007

Whitney Tilson's 2007 Wesco Annual Meeting Notes

May 9, 2007

This is an advance copy intended only for those who have registered for the 3rd Annual New York Value Investing Congress. To register, please go to www.ValueInvestingCongress.com

***Note**: Words in [brackets] are my comments, edits or, when I missed something, my best guess of what was said.*

For my columns and notes on previous Berkshire and Wesco meetings, click here.

OPENING REMARKS

I note that this year we're in a tent. It's amazing that a tent can be made to work so well. It's a tribute to our civilization. If our ancestors had been in a tent, it would not be like this one, with air conditioning and so forth.

It's amazing that all you people come. You know, I didn't set out in life to become the assistant leader of a cult. [Laughter] As they say, experience is what happens when you're looking for something else.

It's amazing that many of you come to this meeting after the Berkshire meeting for so many years. It's like the person at the Catholic church who doesn't want the catechism changed.

People are obviously here to some extent to leave a little wiser than when they came. It's very hard to do this by merely hearing someone else talk. That's why most teaching is vivid. For example, when they trained soldiers for World War II, they shot real bullets above them, which really taught them to hug the ground.

That's why so many learn lessons the hard way, through terrible experience. Mark Twain once said that picking up a cat by its tail yielded better learning than was available in any other fashion. But that's a terrible way to learn things. Another comic thought man ought to learn vicariously: you shouldn't have to try it to learn not to pee on an electrified fence. [Laughter]

It's really hard to get ideas from one mind into another. That's why learning institutions are so selective.

I want to do something I haven't done before. I feel obligated because so many of you came from such great distances, so I'll talk about a question I've chosen, one that ought to interest you: Why were Warren Buffett and his creation, Berkshire Hathaway, so

unusually successful? If that success in investment isn't the best in the history of the investment world, it's certainly in the top five. It's a lollapalooza.

Why did one man, starting with nothing, no credit rating, end up with this ridiculous collection of assets: $120 billion of cash and marketable securities, all from $10 million when Warren took over, with about the same number of shares outstanding. It's a very extreme result.

You'll get some hints if you read Poor Charlie's Almanack, which was created by my friend Peter Kaufman, almost against my will – I let him crawl around my office when I wasn't there. He said it would make a lot of money, so he put up $750,000 and promised that all profits above this would go to the Huntington Library [one of Munger's favorite charities]**.** Lo and behold, that's happened. He got his money back, and the donee's receiving a large profit. Some people are very peculiar, and we tend to collect them.

A confluence of factors in the same direction caused Warren's success. It's very unlikely that a lollapalooza effect can come from anything else. So let's look at the factors that contributed to this result:

The first factor is the mental aptitude. Warren is seriously smart. On the other hand, he can't beat all comers in chess blindfolded. He's out-achieved his mental aptitude.

Then there's the good effect caused by his doing this since he was 10 years old. It's very hard to succeed until you take the first step in what you're strongly interested in. There's no substitute for strong interest and he got a very early start.

This is really crucial: Warren is one of the best learning machines on this earth. The turtles who outrun the hares are learning machines. If you stop learning in this world, the world rushes right by you. Warren was lucky that he could still learn effectively and build his skills, even after he reached retirement age. Warren's investing skills have markedly increased since he turned 65. Having watched the whole process with Warren, I can report that if he had stopped with what he knew at earlier points, the record would be a pale shadow of what it is.

The work has been heavily concentrated in one mind. Sure, others have had input, but Berkshire enormously reflects the contributions of one great single mind. It's hard to think of great success by committees in the investment world – or in physics. Many people miss this. Look at John Wooden, the greatest basketball coach ever: his record improved later in life when he got a great idea: be less egalitarian. Of 12 players on his team, the bottom five didn't play – they were just sparring partners. Instead, he concentrated experience in his top players. That happened at Berkshire – there was concentrated experience and playing time.

This is not how we normally live: in a democracy, everyone takes turns. But if you really want a lot of wisdom, it's better to concentrate decisions and process in one person.

It's no accident that Singapore has a much better record, given where it started, than the United States. There, power was concentrated in one enormously talented person, Lee Kuan Yew, who was the Warren Buffett of Singapore.

Lots of people are very, very smart in terms of passing tests and making rapid calculations, but they just make one asinine decision after another because they have terrible streaks of nuttiness. Like Nietzsche once said: "The man had a lame leg and he's proud of it." If you have a defect you try to increase, you're on your way to the shallows. Envy, huge self-pity, extreme ideology, intense loyalty to a particular identity – you've just taken your brain and started to pound on it with a hammer. You'll find that Warren is very objective.

All human beings work better when they get what psychologists call reinforcement. If you get constant rewards, even if you're Warren Buffett, you'll respond – and few things give more rewards than being a great investor. The money comes in, people look up to you and maybe some even envy you. And if you buy a whole lot of operating businesses and they win a lot of admiration, there's a lot of reinforcement. Learn from this and find out how to prosper by reinforcing the people who are close to you. If you want to be happy in marriage, try to improve yourself as a spouse, not change your spouse. Warren has known this from an early age and it's helped him a lot.

Alfred North Whitehead pointed out that civilization itself progressed rapidly in terms of GDP per capita when mankind invented the method of invention. This is very insightful. When mankind got good at learning, it progressed in the same way individuals do. The main thing at institutions of learning is to teach students the method of learning, but they don't do a good job. Instead, they spoon feed students and teach them to do well on tests. In contrast, those who are genuine learners can go into a new field and outperform incumbents, at least on some occasions. I don't recommend this, however. The ordinary result is failure. Yet, at least three times in my life, I've gone into some new field and succeeded.

Mozart is a good example of a life ruined by nuttiness. His achievement wasn't diminished – he may well have had the best innate musical talent ever – but from that start, he was pretty miserable. He overspent his income his entire life – *that* will make you miserable. (This room is filled with the opposite [i.e., frugal people].) He was consumed with envy and jealousy of other people who were treated better than he felt they deserved, and he was filled with self-pity. Nothing could be stupider. Even if your child is dying of cancer, it's not OK to feel self pity. In general, it's totally nonproductive to get the idea that the world is unfair. [Roman emperor] Marcus Aurelius had the notion that every tough stretch was an opportunity – to learn, to display manhood, you name it. To him, it was as natural as breathing to have tough stretches. Warren doesn't spend any time on self-pity, envy, etc.

As for revenge, it's totally insane. It's OK to clobber someone to prevent them from hurting you or to set an example, but otherwise – well, look at the Middle East. It

reminds me of the joke about Irish Alzheimer's: when you've forgotten everything but the grudges.

So this is a lesson for you to draw on – and I think almost anybody can draw those lessons from Warren's achievement at Berkshire. The interesting thing is you could go to the top business schools and none are studying and teaching what Warren has done. There's nothing nutty in the hard sciences, but if you get into the soft sciences and the liberal arts, there's a lot of nuttiness, even in things like economics. Nutty people pick people like themselves to be fellow professors. It gets back to what Alfred North Whitehead talked about: the fatal unconnectedness of academic disciplines. When people are trying to recruit people to be PhDs in their subjects – the results are often poor.

On the other hand, if you have enough sense to become a mental adult yourself, you can run rings around people smarter than you. Just pick up key ideas from *all* the disciplines, not just a few, and you're immensely wiser than they are. This is not a great social advantage, however, as I can tell you from experience of the early Charlie Munger. To meet a great expert in a field and regard him as a malformed child is not a winning social grace. I got a lot of hard knocks when I was young. You could say I was forced into investing. The world will not ordinarily reward you for correcting other people in their area of expertise.

Accounting is a noble profession. It came out of Northern Italy, Venice, spread, and became part of standard accounting textbooks. The people who carry the torch in accounting are in a noble profession, yet these people also gave us Enron. You could have walked into an insane asylum, which was better than Enron, and yet accountants blessed it. So there are defects. I talked to a leading person in the accounting field and said it didn't make sense to let companies mark weird stuff to their own models – that it would lead to disaster. She looked at me like I was out of my mind and asked, "Aren't you for the most current data in accounting? My system is more current and therefore should be better." This mind would score highly on an IQ test, but is scarcely able to throw out the garbage.

There are two factors in interplay a) you need currency and b) you need to set up a system in which it's not easy for human beings to cheat or delude themselves, despite the presence of incentives to do so. If you can't perfectly weigh the relative importance of these two things in contrast, you're a horse's patoot and not qualified to set accounting standards.

If you go into liberal arts, you'll find that education isn't as good as it should be. I wish I had two or three more lives to live, one of which I could devote to fixing colleges. There is much that is good, but much that is utterly awful and only slightly improved in the 65 years since I left it.

You could say that the dysfunction of others has been an advantage to me. That's the way it is. That's really why you're all here. You all want to get more than you deserve out of life by being rational – who doesn't?

Also, an enormous pleasure in life is to be rightly trusted. One of my kids was a computer nerd and his school gave him access to the entire school computer system. He was exultant by the extreme trust. If your friends are asking you to raise their children if they die, you're doing something right. It's wonderful to be trusted. Some think if we just had more compliance checks and process, virtue would be maximized. At Berkshire, we have subnormal process. We try to operate in a web of seamless trust, deserved trust, and try to be careful whom we let in. They act like this at the Mayo Clinic. Imagine if they didn't. Most patients would die.

Well, I've fulfilled as much as I have a stomach for in making some unscripted comments.

QUESTION AND ANSWER PERIOD

[My notes here are organized by topic, not the order in which the questions were asked.]

COMMENTS RELATED TO BERKSHIRE HATHAWAY AND WESCO

Comments on Berkshire

The Munger family has the better part of $2 billion in Berkshire, so there has been some thought as to whether this is a good idea. The answer is that I'm quite content to hold that position and I hope my family members will hold an overwhelming amount of that for a long time. They won't have the same kind of results that I have had getting the position to its present size from small beginnings, but they don't need the kind of results I got.

Berkshire's a very reputable place, full of the right kind of people with the right kind of values. If your expectations are moderate and you like to sleep well at night, it's not a bad place to have your money compared to other stocks. If what you need is 30% compounded for years into the future, our stock is not for you. Compared to the other stocks available to you, it's OK and will stay OK long after Warren and I are gone.

I just had breakfast with Joe Brandon. Gen Re is a hell of a good place. Joe said to me that with $11 billion of net worth and Berkshire's name and reputation, they have lots of desirable options. They ought to do all right if they keep the faith.

We ought to be alright. Berkshire is full of places that are likely to be alright.

As I said on an earlier occasion, if you get Warren Buffett for 40 years and the bastard finally dies on you, you don't really have a right to complain. [Laughter]

Berkshire vs. Wesco stock

It's been very awkward in my position. The truth of the matter is that Berkshire is a better business operation by far. First of all, the guy there [Buffett] is 76. The momentums are way better. That advantage of Berkshire has increased. We would have long ago avoided this duplication except for people like you. You bid Wesco so high that we'd be giving more than we'd be getting if we merged Wesco into Berkshire. So people like you are responsible.

But I like you guys. It's an acquired taste. [Laughter]

Do you prefer to buy equities in Berkshire or Wesco?

Berkshire has bought somewhat faster. The two companies have never followed the same path. They have different reporting requirements. As soon as we announce, people like you follow us in. Sometimes it [whether Berkshire or Wesco buys] happens by

accident. Generally, we haven't been terribly enthusiastic about equities in recent periods. But we like the best equities better than we like bonds. In both companies we're buying more equities.

Constraints of Berkshire's size

We're horribly constrained. It's hard to buy in quantity, even in a large company in a major market. It's a problem of [our] wealth. I hope that problem gets worse and worse. [Laughter] We don't have a way out of this problem. Warren occasionally buys derivatives. Just because I don't like the accounting for some of them doesn't mean we won't own them. Sometimes they're mispriced.

Look at the last 15 things we've bought – they've worked out well, but we have so much size that we haven't spent what we wanted. This won't bring tears. What may bring tears is that we're settling for lesser prospects than we did. Warren said Berkshire's portfolio will outperform the markets by about two percentage points per annum. That doesn't mean we don't find other things to do other than buy a big portfolio of securities. I'm continuously bullish. Berkshire is a great place.

Will Berkshire ever pay out its excess capital?

It's very unlikely that Berkshire will be making large distributions of what you call excess capital, though we would start thinking about such things if we ever got discouraged at turning each retained dollar into more than one dollar of market value for shareholders.

The entity that should be thinking about this is Wesco. It has a lot of capital, capital gains taxes are at all-time low, and we don't have the same prospects as Berkshire, but you cult members make that hard to do because you keep bidding up its shares above intrinsic value. Anyone who wants to leave can sell above intrinsic value. Those of you holding the stock hope we can create more than $1 of value [with each dollar of our retained earnings], and I'm hopeful we can do this, though we won't do as well as Berkshire.

If we thought most shareholders wanted Wesco to distribute capital, we'd do it so fast it would make your head spin. Let us know. I don't think most shareholders want us to do it because they're members of the cult. I don't think we will unless there's some very unusual development.

Can you tell us about the person you want for Berkshire's CIO?

We don't want people who want to learn from us – not that that hasn't already happened. We want someone young enough to have a long run – if it worked with Warren, why not try to get another long run going? We are perfectly positioned to set up some people doing this and watch them for a few years. We never considered doing this until Warren

was 75, but now that he's older, we have. We like a very peculiar mindset. People chosen won't look like standard people. Obviously, we'd like to try to get somebody that reminds us of Warren.

[In response to a second question on this topic]

We're looking for a few people to manage money for a few years, hoping that one or more of them turn into the next Warren. They can be independent money managers doing their own thing. Lou Simpson manages a few billion for us and he can live wherever he wants and operates as he chooses. It makes sense to have a few more Lou Simpsons.

Who will make the decisions on buying entire companies?

The independent subsidiaries [of Berkshire] can acquire companies that fit. They usually check with Warren on the big ones, but they often don't and he never says no.

We have no CIO now. The question of who would acquire whole businesses might fall more to CEO than to the manager of a portfolio and marketable securities. Wherever Berkshire has useful talent, it will use it. We don't have any military-type rigidity.

Buffett's getting better with age

Warren is actually still improving. I know it's hard to believe, but he's in a field where one can actually improve at Warren's age.

Can you imagine the early Warren risking billions in a currency trade and making a couple of billion? He has also made a couple of derivative trades. Warren keeps learning. There has to be a crest to this someday, but I think it's ahead, not behind.

What role does the board of directors play at Berkshire?

The board is a safety valve in case I go completely crazy and Warren doesn't do anything about it. [Laughter] They are eminent people. We're required to have a board with independent directors and since we're required to have such a board, we figured we might as well have a good one.

[He paused here, apparently debating whether to add the following:] Would we have had a board if we were allowed not to have one? No, we wouldn't have a board. [Laughter]

Did you sell your silver position too early because of the Salomon crisis?

We bought it [our silver position] too soon and sold it too soon, but other than that it was the perfect investment. It was all totally voluntary and had nothing to do with Salomon.

Comments on the Salomon crisis

What was interesting about that day was that it would have had reverberations that would have made the Long Term Capital Management blow-up look like nothing if the Secretary of the Treasury, Nick Brady, hadn't reversed the government's decision to suspend Salomon from participating in government Treasury auctions. Nick Brady's family was one of the original shareholders of Berkshire but sold out before Warren came on.

Nick correctly recognized that the New England textile industry was doomed and sold all of the family's Berkshire stock. His cousin held on until Warren came on and even after. By making this correct decision, one branch of the family benefited from lollapalooza effects.

Because of this, Nick Brady knew all about Warren, and I think he trusted Warren. [During their phone call on that fateful Sunday afternoon,] there was a catch in Warren's voice. Faced with a decision that would have had catastrophic impact had they made the wrong decision, but when Nick heard the catch in Warren's voice, he realized how concerned Warren was and trusted him when he said he needed some reversal of an announced Treasury decision.

Getting a good reputation in life can have remarkably favorable outcomes, and not just for Warren. If Salomon had gone under, it wouldn't have been trouble for Berkshire but would have been terrible for the country and Warren.

Views on the insurance business and ethical limits

I don't think the insurance business will be that great for most people in it. I think we will do way better. We have great people. When I was younger, I probably wouldn't have even tried to get into the game. It's like a juggler with milk bottles who ends up juggling ten. Before we knew it, Berkshire had 10 insurance businesses. [Munger asked Gen Re CEO Joe Brandon to comment and he said, "We have the best collection in the world." Munger continued:] That may be an absolutely correct statement. We gradually learned our way into that position. It didn't happen overnight. If you're not a learning machine, it won't happen.

My father had a friend who used to say everyone's the same over the years, only more so. To some extent we're more so. We learned good lessons when we were young. We've been more selective. I don't think we've ever regretted not making a lot of easy money when we decided it was beneath us.

Warren told the story of the opportunity to buy Conwood, the #2 maker of chewing tobacco. I never saw a better deal, and chewing tobacco doesn't create the same health risks as smoking. All of the managers chewed tobacco – it was admirable of them to eat their own cooking. Warren and I sat down, said we're never going to see a better deal; it's a legal product; and we can buy it at a wonderful price; but we're not going to do it.

Another fellow did and made a couple of billion easy dollars. But I don't have an ounce of regret. I think there are a lot of things you shouldn't do because it's beneath you.

Comments on Gen Re

Joe Brandon has had a job with many unpleasant aspects. There were a lot of problems, he had to do brutal, unpleasant work, and many people resisted. But now Gen Re is enormously improved – in fact, I think it's now worth the stock we gave to get it. There was a time we weren't so sure – there was a time before Joe did his work where we weren't as confident of that as we are now.

Comments on Iscar

It's not a Ben Graham stock – in fact, it would be the ultimate non-Ben Graham stock. It's located a few miles from the Lebanese border in Israel. It has a high ROE, doing business all over the earth, using a certain technology to produce carbide cutting tools. The reason I got so high on it so fast was that the people are so outstandingly talented. The idea of being in business with them just struck me worth straining for. We didn't know when we were young which things to stretch for, but by the time we reached Iscar, which we never would have bought when we were young, we knew to stretch for the right people. It's a hell of a business. Everything is right there. Isn't it good that we keep learning? Better late than never.

Berkshire's investment in railroads

Railroads – now that's an example of changing our minds. Warren and I have hated railroads our entire life. They're capital-intensive, heavily unionized, with some make-work rules, heavily regulated, and long competed with a comparative disadvantage vs. the trucking industry, which has a very efficient method of propulsion (diesel engines) and uses free public roads. Railroads have long been a terrible business and have been lousy for investors.

We did finally change our minds and invested. We threw out our paradigms, but did it too late. We should have done it two years ago, but we were too stupid to do it at the most ideal time. There's a German saying: Man is too soon old and too late smart. We were too late smart. We finally realized that railroads now have a huge competitive advantage, with double stacked railcars, guided by computers, moving more and more production from China, etc. They have a big advantage over truckers in huge classes of business.

Bill Gates figured this out years before us – he invested in a Canadian railroad and made eight hundred percent. Maybe Gates should manage Berkshire's money. [Laughter] This is a good example of how hard it is to change one's mind and change entrenched thinking, but at last we did change.

The world changed and, way too slowly, we recognized this.

Berkshire's investment in POSCO

I would argue that what POSCO does is not a commodity business at all – it's a high-tech business. They learned from Nippon Steel and they're now even more advanced. I'd argue that if you have the most technologically advanced steel company in the world making unusual, [non-commodity] stuff, then business can be quite attractive for a long time.

Should USG [a Berkshire holding] have issued stock to fund a recent acquisition?

I'm hesitating because I'm trying to decide whether to duck that question or give the correct answer. [Laughter]

That was a foolish thing to do, but they can't help it: some of them went to business school. [Laughter and applause]

Why don't you sell Precision Steel?

We have this personality that we don't sell businesses because they're a bit on the difficult side. As for Precision Steel, it might even be a decent business. It's our catechism that we don't play gin rummy with our businesses. And, averaged out, the catechism has benefited shareholders because people are willing to entrust us with their businesses that we won't sell. At Precision Steel, there are a couple of good niche businesses. Holding on is a nonevent.

Why did you buy stock in Tesco and J&J?

Ordinarily we don't go into reasons for buying things. Obviously, we think they're very respectable enterprises. One is the dominant grocery retailer in England and J&J has one of the great long-term records in its field.

These are just portfolio securities. We expect to moderately outperform the market with these securities.

Wesco's surety insurance subsidiary

Wesco's surety insurance subsidiary [Kansas Bankers Surety] insures small banks. That is a wonderful business because it knows what it knows and knows what it doesn't know. By specializing in a particular area, it does well. It's like a specialist in an ecosystem: it occupies a tiny niche and does it well. You just have to look at the numbers – underwriting profits year after year – to know it's a very good business. We're capable of making those decisions.

ADVICE ON INVESTING

Is value investing becoming more widespread?

I think our way of looking at things will become more popular. In fact, it already is a lot more popular than it was decades ago. I used to look out at this group and it was 20 people. The increased popularity of the investment style will not make it easier for all of you to make a lot of money. All these smart people competing will make it harder, but that's not all a bad thing: maybe some of you will have to make money less the way we did and more the way some engineer does.

Efficient markets

If markets were efficient, this tent wouldn't be so full. Some business schools are teaching properly, but the world grew up amidst a different fashion, encouraged by academics of the era. What we believe is simple, and many avoid it because of that simplicity. They want to be experts. And how can you be an expert if it's simple? Also, execution is difficult – and people don't like to fail.

The whole institutional reward system encourages different behavior and thought. If you went to work at a big firm, you'd grind your way up. It's a hierarchy. Nobody cares about how to do it better. And by the time you'd been there 10-15 years, you'd be thinking their way. This didn't happen to Warren.

[Wesco board member] Peter Kaufman came into a business [Glenair] and became the CEO in his early 30s, so he's been the CEO a long time. The whole place is twenty or more times bigger. That's a Berkshire experience, but that's not normal. Normal bureaucracy doesn't reward an attitude like ours.

Where are there market inefficiencies?

Two markets are inefficient: very small ones (which are not much use to Berkshire, with its $120 billion), and ones where crazy people are doing crazy things, especially if they're selling. From time to time, the big markets have some crazily mispriced securities in them. But there's no question that in small markets there's a lot of opportunity to find mispricings.

Is the Chinese stock market a bubble?

The Chinese market is divided into two parts: Shanghai and Hong Kong. The Shanghai market shows some signs of gross excess and I have no interest in what's traded there given prices at present. But there are other parts of the Chinese market that are at least interesting. We don't comment on individual securities for obvious reasons.

Comments on Andy Kilpatrick

I don't think he's the greatest Warren Buffett fan, but he's the most resolute. Andy met Warren through the Washington Post connection and Andy had the same experience that St. Paul had on the road to Damascus. Andy was decisive, he bought all the Berkshire stock he could on margin, it went up, he bought more, it went down and he sold just enough. In due course, became quite rich. He did this by making one decision.

Not only Peter Kaufman [Poor Charlie's Almanack], but Andy self-published his book [Of Permanent Value: The Story of Warren Buffett].

A lot of other people met Warren and said, "Who in the hell is this bumpkin?" Now they've had to pretend they bought Berkshire.

COMMENTS ON BUSINESS AND ECONOMIC MATTERS

Tax rate for hedge funds and the concentration of wealth

If you're running a hedge fund, you're paying the lowest taxes, lower than a college professor or a taxi driver. This is madness of a sort. It would not surprise me if this changed in the near future.

There's an enormous concentration of wealth in people who don't make or invent anything. It *can't* be good for our system to create this new kind of hero if our graduating brilliant young give up engineering to go into trading derivatives. This is rewarded by a peculiarity in the tax code, but it'll probably change.

If you have a Jasper Johns painting, this is the world for you. These hedge fund guys seem to like Jasper Johns paintings and what's $120 million if you made $1.7 billion last year? That's the world that we live in and you gotta admit it's very interesting.

Subprime and the rating agencies

The rating agencies have prospered mightily, and their most likely source of embarrassment is subprime paper. Overall, they do a good job, and you always miss things with the benefit of hindsight. I would not predict they encounter great distress. If you want to pick things to disapprove of, the rating agencies would be far down on the list.

You might pick many originators of the subprime mortgages. They are some of the most disgusting people we've been able to produce, and many of them belong in the lowest circle of hell. There will always be such people, making money by misleading people. You'll always get people like the worst commissioned salespeople in the mortgage brokerage business. This isn't the real tragedy.

The real tragedy is the people higher up at the Wall Street banks who only asked if they could sell it, not if they should do it. They violated engineering principles and ethical principles.

There's nothing wrong with giving a mortgage to the deserving poor. Here's a guy who's working hard, etc., and even if you give him a 90% or 100% mortgage, he'll pay it. Making such loans worked and was good for us and the nation.

But if you look for the undeserving, dishonorable, addicted people with silly views on their own entitlement – if you start giving them phony mortgages so they can drink more, gamble more – it's like pouring gasoline on the floor and throwing a match. I would argue that in very high places in America, it's not enough to call it folly. It's sin-folly. It's sad that that much terrible behavior came in, due to the self-serving bias. Because they made easy money doing it, they rationalized it.

Dean Kendall of the University of Michigan music school once told a story: "When I was a little boy, I was put in charge of a little retail operation that included candy. My father saw me take a piece of candy and eat it. I said, "Don't worry. I intend to replace it." My father said, "That sort of thinking will ruin your mind. It will be much better for you if you take all you want and call yourself a thief every time you do it."

It's a good story and we need more Dean Kendalls in the high reaches of American business. This and envy cause so much trouble. They account for so much of what you see in the abuses of the subprime field.

We knew how to do it once. The subprime for the deserving poor worked, but egalitarianism and biases led to a big mess.

Why hasn't the declining dollar led to increased inflation?

The dollar's been going down like crazy, but the prices at Costco [Munger's on the board] have shown no inflation for many, many, many years. It's a good question. A lot of economics professors would say it couldn't happen, but it did. It's very important. There's been an unusual set of circumstances. It's easy for me to tell you it matters. But how it matters – if I were able to do that, I wouldn't be qualified to sit here. The answer is, I don't know.

Is there a trend in the private equity business?

Of course there's a trend. The LBO funds get larger and larger and buy larger and larger businesses, so it's a huge trend.

It's a different lifestyle than Berkshire's. We almost never sell – we don't want to do that. We don't want to play gin rummy with our friends, dumping five businesses and getting five new ones. We aren't buying to resell.

The leveraged equity crowd is getting bigger and bigger and bigger. What's happened is endowments and pension plans are believing in the tooth fairy. With assets being bid up, they're not getting enough return from ordinary investments from stocks and bonds. Then silver-tongued people came along and said you don't have to suffer low returns. Give us the money, we'll lever up, pay us a lot of compensation and we will give you 15% not 5%. It's worked – not as well as claimed; there's dubious use of statistics – but for good shops, it works.

Then, a lot of envy sweeps the field. Yale can't stand Harvard making more. Envy is a huge motivator, though it's seldom admitted. In my whole life, I've never had someone say, "Charlie, I'm doing this out of envy."

In venture capital, except for a handful of firms at the top, the returns are lousy. This will eventually happen to the LBO firms as well. God has not decided that anyone who wants 15% can get it.

How do you invest the funds of the hospital you're chairman of?

The nonprofit hospital of which I am the chair is really nonprofit. It loses so much money in a good year it's awkward and a bad year is something awful. Given the conditions under which we labor, we leave all money in short-term instruments. We need all our assets in a liquid reserve.

I'd like to have a hospital where my biggest problem is what to do with the surplus, but that has not been my lot in life.

I don't think hospitals have different investment needs than other places. I don't think the investment process would be any different.

Comment on UnitedHealth, its CEO and the options backdating scandal there

It's hard to say anything but that that was very regrettable behavior. The man lost his job and he deserved to.

View of lawyers

The standard way lawyers think is to weigh both sides. There's forced objectivity and a procedural system. That's a huge plus. So if that's what you're talking about regarding law practice, that's good, but there's a lot that's not good, a lot that's drifted away. It's not at all uncommon that billing rates will exhaust the amount in dispute before you get to trial. If you're doing this as a lawyer, that's a moral minefield.

The legal profession attracts a lot of smart people who can express themselves well in words and numbers. There are many good people coming out because many good people are going in. Yet much of what law schools do is a joke.

View of investment bankers

At Salomon we asked, "Where is the list of things you won't do because they're beneath you?" We never saw it. Envy and greed lead people to doing almost anything that looks profitable and does not require use of a machine gun. Investment bankers were better when I was young. They used to care about the quality of deals – they cared a lot. Ethics attenuated a lot. This was not good.

The deterioration would be an interesting subject for social science. You'd have to understand psychology – it would be very difficult for somebody to do it.

Why is the high road the best way in investment banking? It's not very crowded. [Laughter]

The possible rise of protectionism

It's hard to predict if there will be a lot of protectionism. At the current time, a flood of imports is changing the world. Some ordinary guys are having a tougher time and feel that China is oppressing them.

MENTAL MODELS

Using mental checklists

I'm a great believer in solving hard problems by using a checklist. You need to get all the likely and unlikely answers before you; otherwise it's easy to miss something important.

Using superior thinking to get ahead

[Referring to his opening remarks in which Munger said "At least three times in my life, I've gone into the other field and succeeded." I asked what those three times were. He replied:]

The first two are easy: real estate development and managing money. I can't claim to have clobbered the locals in the third, so I don't want to talk about it. [Laughter]

Can you give an example of giving up a closely held idea?

Even as fanatical as I am about throwing away a wrong idea and grasping a successful one, I have a hard time coming up with a recent example. Certainly I've become way more disenchanted with certain people and that seems to happen all the time. In that sense, I seem to keep learning a lot. I've discarded so many ideas long ago that I don't have many left.

Anytime you catch something just barely, where if you hadn't caught it you'd be in terrible trouble, you're using a checklist, even if not consciously.

I'm answering the question I'm capable of answering, instead of the one you asked.

I invert: I try to figure out what I don't like and try to avoid it. It's worked wonders for me.

What is your favorite human misjudgment?

My favorite human misjudgment is self-serving bias: how the brain subconsciously will decide that what's good for the holder of the brain is good for everyone else. If the little me wants it, why shouldn't the little me have it? People go through life like this. I've underestimated this phenomenon all my life. People go bonkers taking care of their own self-interest. It's a sea of miscognition. People who write the laws, people who treat patients, who experiment with rats, all suffer horribly from this bias.

Hardly anything could be more important to the study of law than the study of psychology, but there's a taboo against it. You see many people who've gotten straight A's at law school, but they screw up in dealing with self-serving bias.

I would say that the current head of the World Bank [Paul Wolfowitz] had an elementary question: as head of the Bank, a lot of people hate you, so how bright do you have to be to distance yourself from a question of a large raise from your live-in girlfriend? He sent it to the lawyers, they hemmed and hawed, and he lost his moorings. Even a child shouldn't make his obvious mistake. Similarly, I'd guess President Clinton would have had a better record if he'd had better insight on certain subjects. Note that I carefully picked one from each party. [Laughter]

Nuttiness in the world

I once asked a doctor why he was still doing an obsolete cataract operation when a new, better one had been developed. He said, "Because it's so wonderful to teach!" He only changed when patients voted with their feet. And this was at one of the best medical schools!

There's a lot of miscognition. If you can just tune out all of the big folly, you'd be surprised how well you can do. There's a lot of nuttiness. Who gives up an operation he likes doing and is really good at? It's a really human thing to cling to things most practiced. This happens even in physics. A lot of people cling to bad ideas. If the brightest people in the world do this, imagine everyone else.

If you can train yourself not to do this, you'll be way ahead. If you come all the way to Pasadena from New Delhi to hear a guy well into his 84th year say something so obvious, not everyone would agree this is wise. [Laughter]

Opportunity costs

I just wanted to do the best I could reasonably do with the talent, time and resources I had available. That's what I was doing then and now. Everything is based on opportunity costs. Academia has done a terrible disservice: they teach in one sentence in first-year economics about opportunity costs, but that's it. In life, if opportunity A is better than B, and you have only one opportunity, you do A. There's no one-size-fits-all. If you're really wise and fortunate, you get to be like Berkshire. We have high opportunity costs. We always have something we like and can buy more of, so that's what we compare everything to.

All of you are in the game of taking the lot you have right now and improving it based on your opportunity costs. Think of how life is simplified if you approach it this way.

ADVICE ON LIFE AND OTHER COMMENTS

[After his microphone stopped working temporarily:] I've worn out the patience of my listeners, but I've never worn out a microphone before. [Laughter]

Munger's need for "glorious independence"

There's a poem by Burns, the great Scottish poet, where he urges Scots to work hard, even connive, to get a glorious independence. You don't have to listen to me very long to know my views wouldn't be welcome everywhere, so I decided I needed glorious independence, which required that I be a man of independent means. I didn't buy a new car until I was about 60 and I was very rich before then. I wanted independence for the same reason George Bernard Shaw sent his mom out to work: I wanted to make a mental man of myself. Warren kids me about this.

I said I would sell the best hour of the day to myself in order to improve myself. Only then would I sell the rest of my time to my clients. Of course, when I was in a demanding situation, I'd make an exception. To make a man of yourself intellectually, you need to work at it. I don't think even [famed mathematician] Johnny von Neumann did it naturally.

For many people it's good that they're extra busy. They're not good thinkers, so you get more out of them if they just keep doing what they're doing. But if you're a person of good cognition, you can learn a lot more if you put your mind to it. I don't think there's any substitute for just sitting and thinking.

Nature vs. nurture

In nature vs. nurture, nature is way more important than people give it credit for. That's not to say people can't improve, but nothing on earth could make me succeed in music or basketball. You need to recognize where nature has been kind and play a game where

nature has given you the greatest talent. Man is the prisoner of his talents. I'm afraid that's the hand we're given to play in life. If you're 5' 2", I don't think you want to play basketball.

People who are a credit to our civilization

I don't know much about Whole Foods or Google. I tend to think there's a fair amount of puffery when it comes to organic claims. Yet I read a very interesting article in Harvard Magazine about how modern cows, with artificial insemination, are kept pregnant 300 days a year and their hormones go into the milk. Is this a problem? That's an interesting question. It's a credit to Harvard to publish it. It's not a problem with skim milk. The kind of person writing that article is a credit to the civilization.

I went to the University of Michigan a few months ago and went to the Biology Department, including the medical school and hospital. They decided they'd go totally self-insured. If they made a mistake, they'd admit it – no hiding stuff. They'd go to the bedside and admit it. They did what they probably should have done from the beginning. Now their malpractice costs are lower. The guy who runs this is a credit to the civilization. This is not present in the hospital of which I'm chair. I can't get there from where we are, but I'd like to.

There are lots of people like this. I live in a state where they gerrymandered districts so that, mostly, only certified nuts can win the primary, and once they're elected, can't be voted out. How bad is this system? I'd like a world with more people like those in the [University of Michigan] hospital.

Global warming

Warren has never had any scientific training and he avoids these questions because he says, "I have no specific aptitude and I won't make a fool of myself." I'm almost as ignorant as Warren, but I am a Cal Tech-trained meteorologist, though it was a long time ago and this subject was then a very empirical activity.

My own view is that it's overwhelmingly likely that increased concentration of CO2 is leading to some warming. For Al Gore, once he has this insight, he thinks we should do a lot about it right now, even though he has a house with 20 rooms.

For me, what we should do about it right now is a very complicated question. The prognosis for a decline in CO2 emissions from China and India – which have many, many people who want to live more like we do – is zero. Before we are done, I suspect we'll change the reflectivity of the earth and play a lot of other tricks. But there's no simple answer like just sign treaties with people who are going to hugely multiply their own emissions.

It's a problem I'm not going to have to deal with personally. I'll bequeath it. It's very important, but it's not the end of the world if the world warms a few degrees. If some

islands have to be depopulated, and if it happens over 100 years, with population growth of 1-2% per annum, it can be dealt with. As I said at the Berkshire meeting, with enough time, these things can be adjusted to. I don't think this is likely to be an utter calamity for mankind. It is something that we can deal with.

Book recommendations

Peter Bevelin, the author of Seeking Wisdom, is here and he sent me the book The Martians of Science. It's a hell of a book about five Hungarian physicists, driven to the United States by Hitler, who contributed much to science here. I can't recommend it enough.

I read the new biography of Einstein by Isaacson [Einstein: His Life and Universe]. I've read all the Einstein biographies, and this is by far the best – a very interesting book.

What do you think Ben Franklin's greatest regret was?

Well, his wrong medical decision killed his only son. But, mostly, he didn't allow himself much regret. Franklin made a very ill-advised marriage. He married someone who wasn't suited to the life he ended up living. That's hugely important. All honorable people will do the best they can with the bed they've made. Franklin did that and did not allow himself to feel regret. All in all, he had a fabulous life.

Thoughts on his advancing age

I'm getting more experienced at aging. I'm like the man who jumped off the skyscraper and at the 5th floor on the way down says, "So far this is not a bad ride." [Laughter] I'm getting better with aging. I'm not going to complain about age because if I didn't have it, I'd be dead.

Can you tell us about your worst experience and how you dealt with it?

I'm not going to answer that.

Career advice

[The questioner asked Munger for advice on which of two career choices he should pursue – I forget what they were.]

A lot of people who follow either of the courses will find it very difficult. You're a young person. You can't give that kind of answer in a one-size-fits-all way. It depends on your talents. The decision may be forced on you. If you can work with people you really admire, role models, then that's where you should go.

Ideally, you would have figured it out by now. If you're only now asking that question well along in your business school career, then your business school is about as effective as I would have guessed. [Laughter]

The importance of reading

It's a good question, which brings up a very interesting fact. How did Berkshire's track record happen? If you were an observer, you'd see that Warren did most of it sitting on his ass and reading. If you want to be an outlier in achievement, just sit on your ass and read most of your life. But they fire you for that!

Look at this generation, with all of its electronic devices and multi-tasking. I will confidently predict less success than Warren, who just focused on reading. If you want wisdom, you'll get it sitting on your ass. That's the way it comes.

Deserve what you want

The best legal experience I ever got when I was very young. I asked my father why he did so much work for a big blowhard, an overreaching jerk, rather than for his best friend Grant McFaden. He said, "That man you call a blowhard is a walking bonanza of legal troubles, whereas Grant McFaden, who fixes problems promptly and is nice, hardly generates any legal work at all." My dad was teaching me a lesson and it worked.

Considering its size, Berkshire has supported fewer lawyers than any company I can think of. We've gone through the world like Grant McFaden, the pioneering Omaha Ford dealer.

Figure out what you don't want and avoid it and you'll get what you do want. Warren had the same instincts I had. We haven't had our share of disappointed, angry people that ruin so many lives. It's easy to get into that position. Ask the question: How can you best get what you want? The answer: *Deserve* what you want! How can it be any other way?

Views on Social Security

In the U.S., I think we'll meet the Social Security problem. As long we can keep GDP per person growing at, say, two percent per annum, I think we can meet this problem by allocating a little bit bigger slice of a growing pie. I differ with most of my Republican friends on this.

In New Zealand, they had a rebellion and a counter-rebellion. And New Zealand's working. I don't think we'll have a big problem.

The U.S. role in the world

We're used to being the most important place in the world. Every previous country in this position lost it. We'll be the same. Why not? Sure, the leadership of the world will eventually change.

What are the world's greatest dangers?

The biggest problem is obviously some sort of war that goes nuclear or pathogenic. That problem is so hard that most people shove it to the side and hope it works out.

I would argue it's probably not a good idea for the human population to double from here. I read some paper that expressed a lot of confidence that this won't be a problem, but put me down as dubious. And having all of the nondeveloped populations grow to our living standard will have all sorts of environmental consequences.

I think you can get civilizations that can deteriorate into god-awful conditions, where you have a government of kleptocracy, an awful, corrupt, brutal, stupid system, full of intramural hatreds. Our third problem is that we get a lot more of that. Look at the craziness in the Middle East. A lot of people are not just ideological, but religious. There are a whole lot of young men with not much hope, future or much to do. This is very explosive and dangerous and there are not many examples where this is getting fixed. Maybe Turkey?

But the world has always had these sorts of defects. It makes us treasure what we have. This room is full of extraordinarily fortunate people. If you think you're having a hard life, you got on the wrong planet.

More on terrorism

I think we've been very lucky that the terrorism is the U.S. has been as low as it's been, and the future probably will be worse. There's a lot of terrorism in the Middle East. It's a very serious problem, and I don't think it'll go away. What you can't fix you have to live with. We're trying to fix it as best we can, though I question when [at airport security] an old lady with her kids gets frisked and a guy with a bushy beard and a thick accent goes right through, but it's politically incorrect to give special attention in a logical fashion.

WESCO FINANCIAL CORPORATION

Annual Report 2007

Form 10-K Annual Report 2007

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated net "operating" income (i.e., before realized investment gains shown in the table below) for the calendar year 2007 increased to $93,405,000 ($13.12 per share) from $92,033,000 ($12.93 per share) in the previous year.

Consolidated net income increased, from $92,033,000 ($12.93 per share) in 2006, to $109,161,000 ($15.33 per share) in the current year. The 2007 figure included realized investment gains of $15,756,000, after taxes ($2.21 per share).

Wesco has four major subsidiaries: (1) Wesco-Financial Insurance Company ("Wes-FIC"), headquartered in Omaha and engaged principally in the reinsurance business, (2) The Kansas Bankers Surety Company ("Kansas Bankers"), owned by Wes-FIC and specializing in insurance products tailored to midwestern banks, (3) CORT Business Services Corporation ("CORT"), headquartered in Fairfax, Virginia and engaged principally in the furniture rental business, and (4) Precision Steel Warehouse, Inc. ("Precision Steel"), headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses.

Consolidated net income for the two years just ended breaks down as follows (in thousands except for per-share amounts)[1]:

	Year Ended			
	December 31, 2007		December 31, 2006	
	Amount	Per Wesco Share[2]	Amount	Per Wesco Share[2]
Operating earnings:				
Wesco-Financial and Kansas Bankers insurance businesses —				
Underwriting	$ 7,040	$ .99	$ 5,164	$ .73
Investment income	65,207	9.16	58,528	8.22
CORT furniture rental business	20,316	2.85	26,884	3.78
Precision Steel businesses	915	.13	1,211	.17
All other "normal" net operating earnings (loss)[3]	(73)	(.01)	246	.03
	93,405	13.12	92,033	12.93
Realized investment gains	15,756	2.21	—	—
Wesco consolidated net income	$109,161	$15.33	$92,033	$12.93

(1) All figures are net of income taxes.

(2) Per-share data are based on 7,119,807 shares outstanding. Wesco has no dilutive capital stock equivalents.

(3) Represents income from ownership of the Wesco headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the insurance subsidiaries, less interest and other corporate expenses.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The foregoing supplementary breakdown is furnished because it is considered useful to shareholders. The

total consolidated net income shown above is, of course, identical to the total in our audited financial statements.

Insurance Businesses

Consolidated operating earnings from insurance businesses represent the combination of the results of their insurance underwriting (premiums earned, less insurance losses, loss adjustment expenses and underwriting expenses) with their investment income. Following is a summary of these figures as they pertain to all insurance operations (in 000s).

	Year Ended December 31,	
	2007	2006
Premiums written	$ 54,839	$55,510
Premiums earned	$ 54,411	$54,149
Underwriting gain	$ 10,831	$ 7,944
Dividend and interest income	89,716	83,441
Income before income taxes	100,547	91,385
Income taxes	28,300	27,693
Total operating income — insurance businesses	$ 72,247	$63,692

Following is a breakdown of premiums written (in 000s):

	2007	2006
Wes-FIC reinsurance	$ 35,346	$35,710
Kansas Bankers primary insurance	19,493	19,800
Premiums written	$ 54,839	$55,510

Following is a breakdown of premiums earned (in 000s):

	2007	2006
Wes-FIC reinsurance	$ 34,998	$33,323
Kansas Bankers primary insurance	19,413	20,826
Premiums earned	$ 54,411	$54,149

Following is a breakdown of after-tax results (in 000s):

	2007	2006
Underwriting gain —		
Wes-FIC	$ 1,403	$ 1,650
Kansas Bankers	5,637	3,514
	7,040	5,164
Net investment income —		
Wes-FIC	59,906	53,732
Kansas Bankers	5,301	4,796
	65,207	58,528
Total operating income — insurance businesses	$ 72,247	$63,692

As shown above, operating income includes significant net investment income, representing dividends and interest earned from marketable securities. However, operating income excludes investment gains of $15.8 million, net of income taxes, realized in 2007.

No investment gains or losses were realized in 2006. The discussion below will concentrate on insurance underwriting, not on the results from investments.

Wes-FIC engages in the reinsurance business. For the past several years, its reinsurance activity has consisted of the participation in several risk pools managed by an insurance subsidiary of Berkshire Hathaway, our 80%-owning parent. The arrangement became effective in 2001 and most recently covered hull, liability and workers' compensation exposures relating to the aviation industry, as follows: for 2006, to the extent of 12½% of the hull and liability pools and 5% of the workers' compensation pool; for 2007, 16.67% of the hull and liability pools and 5% of the workers' compensation pool. The participation rates remain unchanged for 2008. The Berkshire subsidiary provides a portion of the upper-level reinsurance protection to these aviation risk pools on terms that could result in the Berkshire subsidiary having a different interest from that of Wes-FIC under certain conditions, e.g., in settling a large loss.

Wesco's Board of Directors has recently and enthusiastically approved Wes-FIC's most significant reinsurance contract to date: its participation, since January 1, 2008, in an agreement with National Indemnity Company ("NICO"), another Berkshire Hathaway insurance subsidiary, for the assumption of 10% of NICO's quota-share reinsurance of Swiss Reinsurance Company and its property-casualty affiliates ("Swiss Re"). Under this retrocession agreement, Wes-FIC will effectively assume 2% of all of Swiss Re's property-casualty risks incepting over the next five years on the same terms as NICO's agreement with Swiss Re. If recent years' volumes were to continue over the next five years, the annual written premiums assumed by Wes-FIC under this retrocession agreement would be in the $300 million range; however, actual premiums assumed over the five-year period could vary significantly depending on market conditions and opportunities.

It is the nature of even the finest casualty insurance businesses that in keeping their accounts they must estimate and deduct all future costs and losses from premiums already earned. Uncertainties inherent in this undertaking make financial statements more mere "best honest guesses" than is typically the case with accounts of non-insurance-writing corporations. The reinsurance portion of the casualty insurance business, because it contains one or more extra links in the loss-reporting chain, usually creates more accounting uncertainty than in the non-reinsurance portion. Wesco shareholders should remain aware of the inherent imperfections of Wes-FIC's accounting, based as it is on forecasts of outcomes in many future years.

Wes-FIC's underwriting results have typically fluctuated from year to year, but have been satisfactory. When stated as a percentage, the sum of insurance losses, loss adjustment expenses and underwriting expenses, divided by premiums, gives the combined ratio. The combined ratios of Wes-FIC have been much better than average for insurers. Wes-FIC's combined ratios were 93.9% for 2007 and 94.0% for 2006. We try to create some underwriting gain as results are averaged out over many years. We expect this to become increasingly difficult.

Float is the term for money we hold temporarily, and as long as our insurance underwriting results are break-even or better, it costs us nothing. We expect that the new business venture with NICO will significantly increase Wes-FIC's float from its yearend 2007 balance of $94 million, thus providing additional opportunities for investment.

Kansas Bankers was purchased by Wes-FIC in 1996 for approximately $80 million in cash. Its tangible net worth now exceeds its acquisition price, and it has been a very

satisfactory acquisition, reflecting the sound management of President Don Towle and his team.

Kansas Bankers was chartered in 1909 to underwrite deposit insurance for Kansas banks. Its offices are in Topeka, Kansas. Over the years its service has continued to adapt to the changing needs of the banking industry. Today its customer base, consisting mostly of small- and medium-sized community banks, is spread throughout 38 mainly midwestern states. In addition to bank deposit guaranty bonds which insure deposits in excess of FDIC coverage, KBS offers directors and officers indemnity policies, bank employment practices policies, bank insurance agents professional errors and omissions indemnity policies and Internet banking catastrophe theft insurance.

When Wesco purchased KBS, it had been ceding almost half of its premium volume to reinsurers. Now it reinsures only about 15%. Effective in 2006, insurance subsidiaries of Berkshire Hathaway became KBS's sole reinsurers. Previously, an unaffiliated reinsurer was also involved. The increased volume of business retained comes, of course, with increased irregularity in the income stream. KBS's combined ratios were 55.1% for 2007 and 73.8% for 2006. We continue to expect volatile but favorable long-term results from KBS.

CORT Business Services Corporation ("CORT")

In February 2000, Wesco purchased CORT Business Services Corporation ("CORT") for $386 million in cash.

CORT is a very long-established company that is the country's leader in rentals of furniture that lessees have no intention of buying. In the trade, people call CORT's activity "rent-to-rent" to distinguish it from "lease-to-purchase" businesses that are, in essence, installment sellers of furniture.

However, just as Enterprise, as a rent-to-rent auto lessor in short-term arrangements, must be skilled in selling used cars, CORT must be and is skilled in selling used furniture.

CORT's revenues totaled $396 million for calendar 2007, versus $400 million for calendar 2006. Of these amounts, furniture rental revenues were $327 million and $324 million, furniture sales revenues were $62 million and $70 million, and rental relocation revenues were $7 million and $6 million. CORT operated at after-tax profits of $20.3 million for 2007 and $26.9 million for 2006.

When we purchased CORT early in 2000, its furniture rental business was rapidly growing, reflecting the strong U.S. economy, phenomenal business expansion and explosive growth of IPOs and the high-tech sector.

Beginning late in 2000, however, new business coming into CORT began to decline. With the burst of the dot-com bubble, the events of September 11, and a protracted slowdown in new business formation, CORT's operations were hammered, reflecting generally bad results in the "rent-to-rent" segment of the furniture rental business. Obviously, when we purchased CORT we were poor predictors of near-term industry-wide prospects of the "rent-to-rent" sector of the furniture business.

CORT started up a new service in 2001. Originally a subsidiary named Relocation Central, and subsequently integrated into CORT's operations, CORT's rental relocation activities were intended mainly to supplement its furniture rental business by providing apartment locator and ancillary services to relocating individuals. Long CORT's star CEO, Paul Arnold is in process of expanding CORT's rental relocation services and redirecting its

marketing toward the needs of businesses and governmental agencies who require a skilled and able partner to provide comprehensive and seamless relocation services for the temporary relocation of employees, worldwide. With several websites, principally www.cort.com, www.relocationcentral.com and www.apartmentsearch.com, professionals in more than 80 domestic metropolitan markets, affiliates in more than 50 countries, almost twenty thousand apartment communities referring their tenants to CORT, many ancillary services, and its entrée to the business community as a Berkshire Hathaway company, CORT's rental relocation operations may now be moving in the right direction.

In January 2008, CORT expanded its operations to the United Kingdom through the purchase of Roomservice Group, a small regional provider of furniture rental and relocation services.

CORT's operations are subject to economic cycles. We are pleased with CORT's progress in the past few years; however, we believe that it will likely suffer its share of the downturn as we enter a period of economic contraction. CORT is now a stronger company than it was when acquired by Wesco, helped by several "tuck-in" acquisitions, and poised towards long-term growth despite periodic bumps to be encountered along the way.

More details with respect to CORT are contained throughout this annual report, to which your careful attention is directed.

Precision Steel Warehouse, Inc. ("Precision Steel")

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, operated at after-tax profits of $0.9 million in 2007 and $1.2 million in 2006. These figures reflect after-tax LIFO inventory accounting adjustments decreasing after-tax income by $1.0 million for 2007 and $0.6 million for 2006. Precision Steel's operating results for 2006 also reflect expenses, net of insurance recoveries, of $0.3 million, after taxes, in connection with environmental cleanup of an industrial park where a Precision Steel subsidiary has operated alongside approximately 15 other manufacturers for many years. Had it not been for the LIFO accounting adjustments, or the environmental matter discussed in Note 9 to the accompanying consolidated financial statements, Precision Steel would have reported after-tax operating income of $1.9 million for 2007 and $2.1 million for 2006.

Precision Steel's business has been subject to economic cycles. Although the fiercely competitive, chaotic pressures which affected its steel service center business several years ago have abated, Precision Steel is continuing to suffer the ongoing effects of a long-term reduction in demand caused by customers' (or former customers') unsuccessful competition with manufacturers outside the United States. Precision Steel's revenues decreased 2.7% in 2007, following an increase of 2.8% in 2006, approximately half of which was due to an extraordinary order of shimstock and other industrial supplies from a customer of its Precision Brand Products subsidiary. In 2007, Precision Steel's service center volume was 39 million pounds, down from 46 million pounds in 2006 and 69 million pounds sold as recently as 1999. This decline in physical volume is a serious reverse, not likely to disappear in some "bounce back" effect. Nor do we expect that ongoing price increases like the approximately 66% rise that has occurred since 1999, holding dollar volume roughly level despite a precipitous drop in physical volume, will continue.

Although Precision Steel's recent after-tax operating *earnings* of approximately $1 million per year may signal improvement when compared with its after-tax operating *loss* of

$0.9 million for 2003, we do not consider present operating results to be a satisfactory investment outcome. Recent earnings of Precision Steel compare unfavorably with operating earnings which averaged $2.3 million, after taxes, for the years 1998 through 2000. Because the steel warehouse business may revert to even more difficult conditions, more decline for Precision Steel may lie ahead.

Terry Piper, who became Precision Steel's President and Chief Executive Officer in 1999, has done an outstanding job in leading Precision Steel through very difficult years. But he has no magic wand with which to compensate for competitive losses among his best customers.

Tag Ends from Savings and Loan Days

All that now remains outside Wes-FIC but within Wesco as a consequence of Wesco's former involvement with Mutual Savings, Wesco's long-held savings and loan subsidiary, is a small real estate subsidiary, MS Property Company, that holds tag ends of appreciated real estate assets consisting mainly of the nine-story commercial office building in downtown Pasadena, where Wesco is headquartered. Adjacent to that building is a parcel of land on which our construction of a multi-story luxury condominium building is nearing completion. We are also seeking city approval of our plans to build another multi-story luxury condominium building, at a later date, on a vacant parcel of land in the next block. For more information, if you want a very-high-end condominium, simply phone Bob Sahm (626-585-6700). MS Property Company's results of operations, immaterial versus Wesco's present size, are included in the breakdown of earnings on page 1 within "other operating earnings."

Other Operating Earnings (Loss)

Other operating earnings (loss), net of interest paid and general corporate expenses, amounted to ($0.1 million) in 2007, versus $0.2 million in 2006. The components of the $0.1 million of other operating loss in 2007 were (1) rents ($3.9 million gross in 2007) principally from Wesco's Pasadena office property (leased almost entirely to outsiders, including Citibank as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiaries, less (3) general corporate expenses plus minor expenses involving tag-end real estate.

Consolidated Balance Sheet and Related Discussion

Wesco carries its investments at fair value, with unrealized appreciation, after income tax effect, included as a separate component of shareholders' equity, and related deferred taxes included in income taxes payable, on its consolidated balance sheet. As indicated in the accompanying financial statements, Wesco's net worth, as accountants compute it under their conventions, increased to $2.53 billion ($356 per Wesco share) at yearend 2007 from $2.40 billion ($337 per Wesco share) at yearend 2006. The main causes of the increase were net operating income after deduction of dividends paid to shareholders, and appreciation in fair value of investments.

The foregoing $356-per-share book value approximates liquidation value assuming that all Wesco's non-security assets would liquidate, after taxes, at book value.

Of course, so long as Wesco does not liquidate, and does not sell any appreciated securities, it has, in effect, an interest-free "loan" from the government equal to its

deferred income taxes of $322 million, subtracted in determining its net worth. This interest-free "loan" from the government is at this moment working for Wesco shareholders and amounted to about $45 per Wesco share at yearend 2007.

However, some day, parts of the interest-free "loan" may be removed as securities are sold. Therefore, Wesco's shareholders have no perpetual advantage creating value for them of $45 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than $45 per Wesco share.

Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway. Moreover, the quality disparity in book value's intrinsic merits has, in recent years, continued to widen in favor of Berkshire Hathaway.

All that said, we make no attempt to appraise relative attractiveness for investment of Wesco versus Berkshire Hathaway stock at present stock-market quotations.

Last year we reported that Wesco had held more than $1 billion of cash equivalents and fixed-maturity investments since early in 2003. In the latter part of 2007 Wesco invested $802 million, net, in marketable equity securities. Of its $3.1 billion of assets at December 31, 2007, $565 million is invested in cash equivalents and fixed-maturity investments. Unless significant additional amounts can be attractively reinvested in acquisitions, equity securities or other long-term instruments of the type that helped cause the long-term growth of Wesco's shareholders' equity, future returns on shareholders' equity will probably be less than those of the past. Due to the current size of Wesco and its parent, Berkshire Hathaway, Wesco's opportunities for growing shareholders' equity are unlikely to be as attractive as in the past.

The Board of Directors recently increased Wesco's regular dividend from 37½ cents per share to 38½ cents per share, payable March 6, 2008, to shareholders of record as of the close of business on February 7, 2008.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Shareholders can access much Wesco information, including printed annual reports, earnings releases, SEC filings, and the websites of Wesco's subsidiaries and parent, Berkshire Hathaway, from Wesco's website: www.wescofinancial.com.

Charles T. Munger
Chairman of the Board
and President

February 27, 2008

2008 Wesco Shareholder Meeting: Detailed Notes
by: Shai Dardashti posted on: May 09, 2008 | about stocks: BRK.A / BRK.B / WSC

Wesco Annual Meeting, Pasadena CA 2008
May 7, 2008

Notes courtesy of Peter Boodell; thank you!

http://valueinvestingresource.blogspot.com/2008/05/2008-wesco-shareholder-meeting-detailed.html

(As is standard, no recording equipment was used to reproduce these notes. My high school typing teacher gets all the credit. As a result, these notes are recollections only – not quotes, and should not be relied upon as a literal transcript. –PB)

CM: Testing, can you hear in back? Mr Denham has an announcement.

Denham: We ask you not to use your video recorders, thanks.

CM: Welcome to the 49th annual meeting of shareholders of Wesco Corp. Please register to vote at entrance. Anyone wishing to speak, state name, wait for microphone. List of shareholders, 96% of outstanding proxies received. Election of directors? All in favor? [Aye]. Motion is carried.

Six nominees are elected. There will be a long Q&A preceded by Socratic solitaire conducted by the Chairman. Meeting is adjourned.

We now begin Q&A, starting with a long game of Socratic solitaire. During questions, do not ask what we are buying or selling. Any other question is fair game, but we don't agree to answer them.

Because many of you have come from such a long distance, I will talk before I take your questions. I will address two topics, general investment climate [and learnings from Berkshire Hathaway]. We normally avoid [discussing the general investment climate] like the plague. Most assets are priced to a level where it is hard to get excited. It is hard to get 4% yield on a nice apartment, and it doesn't include replacing the carpets. Bonds of strong corporations are 4% yield. Corporate equities are paying 2% pa, growing 4% per year. Such a world isn't the one that made all of you able to come to the meeting. Last generation has been in hog heaven – some bumps, but it had easiest time getting ahead. In the eighteen years that preceded hog heaven, the purchasing power of Yale's endowment went down 60%. They were getting real investment return of 0%, negative. It is not at all impossible that brilliant investors like Yale get bad results in the future.

People are used to laying money aside and investing in standard fashion, and become quite comfortable. It is easy to forget that this isn't guaranteed. Many have recognized

this, but for those running pensions it is difficult [to adjust down assumptions] —like the agony of raising taxes or not looking good as CEO of a company. Some of them wonder if they have signed up for something too hard when running a defined pension plan. That crowd doesn't want to go to a 4-5% assumption, because the pain of the money needed to correct the plan is large. Bonds pay 4%, so they go to alternative investments with profit sharing. They solve the problem by giving 'reasonable return' and sell hedge funds and venture capital fund, mid-stage, late stage, private equity, etc etc etc. They do complex trading strategies, private equity in Africa. They buy timber. [audio system malfunctions] Evidently that machine didn't like the remark. People go into alternatives, and this has worked very well so far. A lot of university endowments have done it – and that is game we are in. If natural return is 5%, getting it to 9% is very unlikely to work well long term. It's going to be difficult for people to have high real returns from deferring consumption. The reason my generation did so well was kind of a fluke, and won't necessarily continue. There will be lots of chicanery in future. Many claim alpha – but really they are just taking earthquake risk. At end of year, when there is no earthquake, they take the money. This is a dishonorable way to invest. It is always easier to get felicity by reducing expectations instead of seeking extreme results.

We have plenty of scandals coming. Lots of rot has gotten into system. It has caused unpleasantness. What is next? I suggest the derivative trading books of the world are next. The accounting allowed in derivative books has been god awful. The morals and intelligence has been god awful. 'I'll be gone and you'll be gone' is phrase they use. What is buried in those books is dangerous, with clearance risks with optimistic assumptions that the accountants allowed. I was at Salomon when interest rate swap accounting was changed. They had a matched book. They were making $7mil, 25m over 18m. Both sides wanted to mark trades profitably. They couldn't retain derivative traders if they didn't have bad accounting. There is a lot of Gresham's law here, where the bad practice drives out the good.

If you run a good bank, and testosterone bank around corner pressures you, there are tremendous pressures to conform. Everyone starts replicating. If every university puts 2% into timber, that can go on a long time. But it is self-fulfilling. When it comes to the unwind, when they all want to get out. A lot of things rely on momentum. Valuations make everyone look good for a while.

We have seen consequences in this mortgage meltdown, not pretty. The amount of knavery and folly revealed in last eighteen months has been unbelievable. I will ask a question, then I will attempt to answer it. Why did this happen? Greed, envy, and terrible accounting was part of it. There was a general lack of conservatism. The engineering mindset that everything must withstand great stresses was thrown out for 'if music is playing, you gotta dance'. I don't feel compulsion to dance, to join the crowd.

One of my favorite stories is boy in Texas, when the teacher asked the class the following question. There are nine sheep in pen, and one jumps out, how many are left? Everyone got it right, and said eight are left. The boy said none are left. The teacher said you don't

understand arithmetic, and he said ‘no you don’t understand sheep’. Sam Goldwin had a saying – ‘include me out’ – it is one of my favorite expressions.

People were distributing stuff that they wouldn’t buy themselves. It is the structure of the modern world. Favorite philosopher: Frankl. He said the systems have to be responsible. People who are making decisions must bear results of decisions. In Rome, the builder and designer stood under the bridge when the scaffolding was removed. In parachutes, you pack your own chute. Capitalism works that way too. At a restaurant, owner is bearing the consequences. If he slips, he doesn’t do well. Frankl would be pleased with restaurant business, and not pleased with investment banking. They sell, take the money, go home – it doesn’t work. And people wouldn’t get by if accountants didn’t bless it. When I was at Salomon, I was on the audit committee. A group came and said that we want to change our accounting, and where our credit is terrible – we want to report automatic profits – ie, to buy counterparties out cheaply because they want to sell. I told them that ‘You will have that accounting over my dead body’. I won that battle, but I lost the war.

Post Enron, accountants made mandatory that where the worse your credit gets the more profits you make. In the old system, the liabilities are always 100% good – it’s the assets you have to worry about. Accountants have thrown it out. They have made it standard. If you ask accountants about it, they say it is so complicated we won’t get to it in 3 yrs. They want something simple to do. A silly procedure and silly result doesn’t bother them as long as it is in some book. That is not wisest way to run a profession.

Legal profession comes in for own opprobrium. Knavish people were deliberately blind. They didn’t want to wrestle punch bowl away from a couple burly drunks. I had a friend who once proposed a rule at the partnership that they would fire one client per year on moral grounds. They would get rid their most venal and dangerous client once a year. That proposal went down in flames. There is a certain amount of deliberate blindness. If you want to prevent, you must have whole lines of activity that people are not allowed to engage in. [more problems with sound system] We are in shadow of Caltech and we can’t get the sound system right. Envy effects corporate compensation. People want to be paid like movie stars rather than archbishops. I don’t think it is necessary. Most would occupy top position at lower compensation rate. It is terrible to civilization. It brings extreme envy into population at wide. In Britain, they took taxes so high that anyone with property was leveled down to growing their own tomatoes. It was not good, very counterproductive. It was matter of envy. The working population required it and it was reaction to envy effects. It is not good to have the results we have had.

If we turn to Berkshire Hathaway, we have faults, but some of standard faults we deliberately avoid. Someone recorded what we would have had if Warren had paid himself 2&20. We would have had much lower taxes, so some other shareholders would have been better off, but Warren would have had 3x what he has now. Would world have been better if it had been run that way? I don’t think so. There is a lot to be said that people in power make money with shareholders, not off them. I’m not asking for an unreasonable ethos. It was compulsory in Athens. Liturgos, means required behavior. You had to give like hell if you were a leader. They had banishment. When language and

traditions impose these… we might need it. We should restrict people in a more old fashioned way.

I remember what I was going to say. Privileges. If you are an investment bank and had to be rescued, there should be limits on leverage and the complications of your business. There should be qualitative limits too. By and large banks behaved well when it worked this way. When I was young, Bank of America – would not have done things they do now. Derivative trading, no good clearance, no rules, excess and craziness feeding on itself. The plain vanilla products got priced down to no profits. They wanted to do complicated stuff. Not sure if it cleared, or other side would be good for it. It didn't bother anyone since they wanted the profits. The hidden trouble in derivative books is awesomely large. Greenspan overdosed on Ayn Rand ethos. He never got it out of his system. As long as axe murders were a natural outcome, then they were okay. I don't think it is necessary – and think you can regulate ax murders away. People talk about marvels of system and risk transfer – but some of our troubles COME from having so much risk transfer.

After South Sea Bubble, Britain outlawed public corporations – only private ones allowed. And they led the world for 100 yrs. A modest amount of liquidity will serve the situation. Too much liquidity will hurt human nature. I would never be tenured if I said that. But I'm right and they are wrong. We don't need worst excesses. We do not need smartest people in science and math in computer driven strategies. This is not a plus for wider civilization. Derivative trading books – is one big clump of excess not having had its denouement.

I am now going to turn to a more interesting subject, the Berkshire Hathaway phenomenon. What are the lessons? On investment side, people are realizing that old fashioned idea of trying to get more value than you are paying for. I think that idea is gaining, and I think a plus for rationality. It doesn't make it any easier. By the nature of things, it will be difficult to make easy money.

How is it organized? I don't think in history of world has anything Berkshire's size organized in so decentralized a fashion. Net amount of bureaucracy is tiny, costs are low, autonomy in subsidiaries is vast, no common culture shuffling people around. How far can this go? This system has gone farther than any other system. Low cost, not a lot of envy effects – where everyone compares everything. People in subsidiaries have a feeling – whereby there is less fealty to headquarters. If you want an imperial headquarters which exacts a big overhead charge on the provinces – they will resent it. Net number of intra-subsidiary transfers is tiny. It has worked well. It can go a lot farther. No one else has been here before.

There are defects to the conglomerate system, where you have a separate quota system driven by headquarters driving provinces to meet central numbers. It causes a lot of expenses at headquarters. GE is good at running a conglomerate system. Berkshire has avoided the minuses. It can go farther. It has a system of running a financial system with low leverage and extreme willingness to let assets run out – that is quite rare. Most

financial institutions talk our talk but don't walk our walk. People can't stand watching a place shrink. If you take General Re, they needed a derivative book like I needed a case of syphilis. It made headquarters more interesting. When we reached for money it wasn't there. Out derivative book produced $400m of losses, and we were more conservative than most places.

[break to fix the sound system]

We have moved to a hard mike, so please return to your seats. Microphone system has an educational value. What they should not be allowed to do – is anything that is too complicated. The hard mike system [vs the wired], lo and behold, is working as it always did. Systems need duplicative systems, back up system one, and back up system two. Complicated systems – the high priests usually don't understand it either. The system just goes out of control. Now we have government guaranteeing credit and then letting investment banks do what they want -- it is a very foolish system. They ought to have behavioral standards. They feel entitled, and that is not what they should feel with privilege of Federal Reserve backing. At Berkshire, we are ridiculously conservative. Even our reserves have reserves. We don't have to renew our credit every Monday morning. We behave in way that we never need to renew our credit, and we still don't need the money.

There have been comments on derivative trades we have done. If other people shouldn't be doing it, why are we? Other people pay us money because people know we don't have clearance risk, we are not at whim of other parties. It is a very different kind of a trade. The only reason we can make those trades is because there aren't many out there who others would trust to make those trades. If you ask me, would I give up all of the opportunities of derivative trading to go back to a simpler cleaner world like engineering of yore--I would do it in a heartbeat. But what we have seen in mortgage market is only an aperitif to what we would see, in a system with bad rules and incentives. Especially with the appetites of males – women wouldn't get us into this mess. In a soccer game, if there were no rules, people would destroy the body of the person on the other side. That is what referee is for. So we need referees to tell boyish adults not to hurt others. I don't make this stuff up. Mark Twain said that truth is stranger than fiction because fiction has to make sense.

Some people call you people cultists, but most here are people who want to learn. It is a very good thing to be in this world. I think we are accidently creating something which is a learning institution, which may work that way for a long time. I don't think Berkshire will perish when Warren dies. I had lunch with two Berkshire executives, and my heavenly days, those two guys are likely to make that business one of best in the world. How could there be a business like that buried in a place like Berkshire? There are very good things in this place. With reputation, comes duty. We should try to earn it. And run it in a way that people who succeed us do the same thing. That is what we are trying to do. Warren will never spend any of the money. He has never given a way a dime he needed. He deserves no credit as a philanthropist. I think we are part of something quite

interesting and worth following. We get calls from people who trust us, and who don't trust anyone else. We don't get many calls like that, but how many of you get any?

I have rambled on. Academic response to Berkshire has been pathetic. It is soft science with enviable formulas. So you had to program a computer to buy only highly volatile stocks in order to make 7% per annum more? But if true, computers would do it. I don't know why people pay attention to those ideas. Down boy, they say, you just don't understand modern finance. And these are grown up people. One man, to whom they gave the Nobel, he kept saying Berkshire just lucky. A six sigma event – he wasn't going to change his theory on the facts available. Business is simple, the details are hard. You need mementoes in place to help you in daily fight.

The only duty of corporate executive is to widen the moat. We must make it wider. Every day is to widen the moat. We gave you a competitive advantage, and you must leave us the moat. There are times when it is too tough. But duty should be to widen the moat. I can see instance after instance where that isn't what people do in business. One must keep their eye on ball of widening the moat, to be a steward of the competitive advantage that came to you. A General in England said, 'Get you the sons your fathers got, and God will save the Queen.' At Hewlett Packard, your responsibility is to train and deliver a subordinate who can succeed you. It is not all that complicated – all that mumbo jumbo. We make bricks in Texas which use the same process as in Mesopotamia. You need just a few bits of ethos, and particularly engineering ethos. Think through the system, and get a margin of safety. Like this backup microphone.

Q1: Thank you Charlie. Financial risk transfers – 500trillion notional value. Sort of like Lilly Toms – things will get worse before they get worse. How does this all unwind?

When the Chinese A-shares went utterly crazy, you could predict this has to collapse. When mortgage excesses got crazy on slicing and dicing by scummy hucksters, it was similar. Derivatives trading books however are not similar. It has no automatic collapse surely to come. Some day it will be a mess, but I don't know when. The mess that would have been if Bear Stearns went under would have been awesome. In CDS, assume $100mil bond issue, and they allow issuance of $100b notional contracts. You have huge incentive for company to go broke. You are not allowed to buy insurance on other people, unrelated parties. There is no reason in America to have vast bets on $100m bond issue to which no one is party. It creates needless complexity and very perverse incentives. They say "it's a free market". The correct adjective is insane.

Q2: Mark from Auz. Last year I was concerned about solvency in banks. I had stocks sent to me in scrip form. Is it now safe to let large corporations hold our stock or safer to keep at home?

Good question. I think risks are low in a cash account at reputable firms. Even in a margin account I think risks are low. It is inconvenient to keep them at home. They all end up in depositaries anyway. Everyone relying on electronic blips. I think fairly safe.

Q3: NY. The amount of derivatives out there today 30tril, 3x GDP. Do you think volumes will present danger in future, have you ever spoken to someone who writes derivatives?

It is complicated. They show large profits. It is peculiar thing – allowed to morph to huge size. Interest rate swaps – overstated. So imperfectly regulated it has a danger to the rest of us.

Q4: CA. Named our son after Warren. We are in market for a house in CA. Wanted your views on house prices.

Housing prices are going down in most places in CA. If you want house in Pasadena, if offer price 1.8m better to start bid at 1.85m. So not going down everywhere. Generally speaking the time to buy a house is when you need one. If you make money on it, it is just a byproduct of you doing your family duty.

Q4: NY. Have you ever asked quality programs at subsidiaries to improve margins?

We try to buy companies so permeated by good ethos that they don't need checking from headquarters. We are trying to live in a seamless web of deserved trust. It has worked for us, and it is the ideal way to live. If your marriage partner has sixty page contract, you shouldn't enter. You want to get a seamless web of trust. If life is hard, you may need a command control system. But we try to avoid it.

Q5: NJ. Railroad regulation?

CM: They are regulated. Earned so little money for years, that I expect rules will be better in future. They have increased capacity in a great way. It has been costly. I would not anticipate regulatory burdens to be high because the railroads have behaved well.

Q6: NY. Rationality? No one is 100% rational. How do you reconcile rationality with irrationality required for successful human relationships?

CM: There are some relationships you couldn't have if you were rational. If someone asked you to join heroin smoking party, you wouldn't qualify if you were rational. I think rationality is of immense benefit. It is a deep moral duty, you must hold it in trust and must hone it. People who are no good at it, they have to go to a different guru. I was born into a different skin.

Q7: WA. Inflation?

CM: If you have competitive advantage, and make 10% of sales, and sales go up 10% due to inflation, you will tend to make a little more money. Whether we will earn less or more, my answer is probably earn a little more.

Q8: UT. General Re. Brandon resignation.

We want to stay away from that subject. But we will stand behind Joe Brandon. He did a magnificent job. We stand behind that observation. I would trust him personally. [applause]

Q9: TX. Howdy. US force feeding 2bil per day. $2b a day to other countries, is it sustainable?

I would not be running twin deficits if I was running this country. I would have policies that didn't push things as far as they have been pushed.

Q10: Dan Rizowsky. Discuss opinions and which model to reach a resolution?

We come to agreement once in a blue moon. Very seldom does he do something I wouldn't do. Once in a while will we change each others' view. We're like an old married couple, humph humph and a nod and it is decided – no conversation necessary.

Q11: Harold from LA. Comments on Alan Greenspan and Ayn Rand and finance professor who can't believe the success of Berkshire. Has there been a time like today when facts on the ground count so little for people in position of power?

You hang around with fellow ideologues. You should avoid this. Many people are totally confident they know the answer. When you have this confidence you need to get over it.

Q12: James Armstrong from Pittsburgh. You have said that Moody's and HBS have the best pricing power of anyone in the world. What causes Moody's moat to shrink?

All the rating agencies with 20/20 hindsight have performed poorly. When you perform poorly you impair your franchise. They weren't quite fundamental enough. Exact example of the kind of thing I was speaking about. In an attempt to make more, they made their position a little worse. This is obvious isn't it?

Q13: Scott from LA. With portfolio of $2m, vs. that of Berkshire, how would your mandate be different? Small vs mid, us vs intl, etc?

If I was managing smaller money I'd be looking in smaller places, I'd look for mispricing. But I don't want to change places with you. [laughter]

Q14: Matt from San Jose. California is single A rating. Only other one is worse is Louisiana.

Both parties have been gerrymandering the legislature. It's hard to get elected unless you're a left or right wing nut. It's a perfectly natural result in an insane system. We are not voluntarily going to change the system. I was the largest donor to the last attempt to change this system. We went down in flames. Stay tuned.

Q15: Sam from Santa Monica. What are your thoughts on the war on terror and the war in Iraq?

A: You're going pretty far afield. Terror is a hell of a problem. People are vastly overconfident in the solution. They are probably making an error.

Q16: Phil, shareholder. What would you do if you were Fed. Suggestions on short and long term solutions to credit crunch?

Changing the system so the system is more responsible. We had margin requirements for decades and the fed forced this. Now with the combination of options and derivatives margin requirements have vanished. Federal Reserve has no power to deleverage. I think the system is seriously wrong.

Q17: Casey from Pasadena. Strong return on intangible assets is what WB likes. What else do you look for?

We buy Kraft these days because we have so much money. We are accepting way lower returns now than we were ten years ago. It is natural consequence of the world getting more competitive.

Q18: What do you think of the treasury market with negative real yields?

It would be depressing if that was my best opportunity.

Q19: Forest from Ft. Worth Texas. Do you look at railroads from a replacement value standpoint?

Do you know what it would cost to replace Burlington Northern today? We are not going to build another transcontinental. And those assets are valuable, have utility. Now they want to raise diesel prices on trucks. Wish I was smart enough to identify this few years earlier. Avoiding the most extreme follies of man makes you better.

Q20: CA. Why has commercial property not fallen as much as residential?

Cap rates came way down and asset values went way up. Financing transactions are getting away from euphoric conditions. A lot of the real estate fortunes have been made with extraordinary leverage. Commercial real estate is not a good business for us but ok for the entrepreneurial types. We shouldn't be doing it.

Q21: Matt from NYC. How does Berkshire thru its subsidiaries manage an annual budgeting process?

We don't have one. Obsessing over budgets creates bad incentives. Just eliminate unnecessary costs. Budget committees tend to do just the opposite.

Q22: John, shareholder. Any recent books you recommend?

I'm a bug for history and science. Yes by Cialdini is good. Most of the psychology professors can't handle this real life material. It's not a perfect book and not as good as Influence. As Warren says, experience is what happens when you're looking for something else.

Q23: Peter, Yonkers NY. Which is better, insurance based float or money management float?

A: In terms of pure utilitarian perspective, you can make way more money in money mgmt than insurance business. There are few businesses as good as money management. Average returns in insurance property and casualty have been pretty pathetic. Once you have enough money you stop accepting compensation and just manage money -- it is more manly. At least 95% of the insurance businesses in the world are worse than ours.

Q24: Ashok from LA. Checklist?

I don't have a simple checklist. You have to work at it a long long time. I still do dumb things after years of hard work. The more big ideas you have the easier. We exclude a whole lot of things because they are in the too tough pile. If you exclude, you do better. Then you must have field where rationality will be rewarded. Some of political ideas – it is very hard to know how they will work out over next few centuries. We are not trying to involve ourselves. We look for things that can be done. But I have no little short list. People who sell strong abs on TV at night might have one. I have no rule for a strong brain.

Q25: Whitney Tilson. NY. You reported earnings, but not a single shareholder asked about it. I was hoping for a comment on Berkshire earnings, and on mark to market derivative losses.

It was a very remarkable occurrence. Like the Sherlock Holmes story – about the remarkable happening with the dog's behavior. Sherlock Holmes asks about the behavior of the dog in the night. "The dog didn't make a sound." "Yes, that was remarkable." That perhaps is teaching a lesson. Those people trust us. They trust Warren, and rightly so. You saw an interesting example of deserved trust working in real world and in Omaha. By the way, we love that position. The accountants don't know what they are doing but I don't criticize them.

Q26: LA. In 25 yrs, where would you see oil production? What year do you see the peak?

This is very flattering, but I don't think question nor my answer will do much for my reputation. We don't know year, and the reason Warren picked up on my answer last weekend so strongly is that it is a radically different world where oil production is down 25 yrs from now, with radical adaptations necessary. Hubbert pretty accurately predicted

peak. If it hasn't peaked, it soon will, and it will go down. At $120 / barrel, there are obvious strains in the production system.

Q27: LA. I went to private school where you donated science building. For many minorities, there are low graduation rates. What can government do to help? What can we do?

Very serious problem, anguish causing. CA had once the best public education system in USA. It is a very sad thing. The private system is very competitive. Warren has suggested that if no one was allowed to use private schools, citizens would make sure public system was good. Not sure Warren is right on this. Personally I am better at lifting top up than the bottom up. Why shouldn't I stick to game where I'm better suited? If you want to know how to raise top higher, I think I could help you a lot. If you want to raise lowest, I don't know how to do it.

Q28: Boston. Swiss Re transaction. Could you add some color? Long tail insurance?

It will be long tail. It won't be a bonanza. It ought to be reasonable, we like Swiss Re.

Q29: I'm curious, you are student of history. Does today remind you of any time in past, and why?

I punched premium channel in hotel in Tokyo, and out came exercise in pornography. I would argue Soddom and Gomorah is still around. I think Athens of Pericles is still around today. Our bullies are similar to past eras.

Q30: LA. How will meltdown affect Brazil and China. Will you invest there?

We have [economic] system which is interdependent. [A slowdown here] would have repercussions elsewhere. Will Brazil have troubles? No. Brazil is favorably located now. If I could get equivalent business prospects I would prefer USA. That iron mine that Brazil owns, you only need small knowledge to know that it is one of best in world. Agriculture – they are in a very strong position. We are not invested there at the moment. We have a small position in Brazilian Real.

Q31: CA. Health insurance?

The health insurance industry gets bad press it doesn't deserve. When medical care fails, they say that characterizes it. But they also prevent a lot of interventions too. But Hollywood assumes everything is bad about health care. I don't know what will happen. I think single payer could happen, and might not be too far in future. In fact it probably would happen, maybe 50% likely if Democrats win both houses.

Q32: LA. Absurd leverage in banking system. Large mess. Only response is that government has taken toxic portion and thrown it onto their books.

Not at all clear what will happen. If government intelligently spent $500bil dollars, it wouldn't be that bad. But now they do it unintelligently. I am not shocked that we all have to pony up $500b. We did it in savings and loan crisis, $150bil.

Q33: CA. Hyperinflation. Real estate and gold?

I don't have a good opinion on that subject. We have not been good at taking advantage of inflation. Net inflation at Costco was zero for ten years. Even Costco is starting to feel it. Not desirable. The previous situation was too good to continue. If it can't go on forever, it will eventually stop.

Q34: Germany. Many managers typically would be carried away by all the success. Is it genes or is it still to come?

Very flattering. Success tends to make most people pretty pompous. Someone once suggested in a public setting, 'Don't you think financial success is making Munger pompous?' An old friend of mine stood up and responded, "No, that is unfair criticism, I knew him when he was young and poor and he was still pompous."

Q35: Beverly Hills. Berkshire has history of acquiring operating companies. Wesco has been less active. Will you get more active?

Berkshire will be better at stuff than we are. We have not bought our last operating business at Wesco, so, stay tuned.

Q36: Auz. Wells Fargo, how did you get comfortable with their derivative positions?

They will not be exempt, but we believe they will have less than their share of troubles. I think they have a better culture.

Q37: CA. Common stock returns going forward? Should we go overseas? So much less transparency… hard to satisfy conservativeness.

P&G and Coca-Cola is in developing world. We have exposure there. For a great many investors, the best way to do it may be to own Coca-cola. We've thought about these things. We do not lack participation in the rest of the world. And we may get more.

Q38: LA. If you were younger, what asset management type would you join?

If doing it again, I'd find someone I really liked being associated with, and I'd serve little time in a pompous place doing a lousy job. But most of jobs are in lousy places. My Harvard law professor used to say – 'tell me what your problem is and I'll try to make it more difficult.'

Q39: Germany. Insurance accounting: Cost or market, or lower of cost or market? Was this good move for accountants of insurance coompanies 30 yrs ago?

Very tough question. Generally speaking, lower of cost or market (standard for inventories) – but various financial types wanted to get away from this. There is a risk of self fulfilling prophecies, like an autocatalytic reaction in chemistry. Conservative insurance companies marking common stocks to market is not a bad thing. If we had lower of cost or market in derivative books, they would have worked better. All intelligent people find it so. You are to be complimented for being bothered by it.

Q40: CA. Average investor should invest in index funds.

All intelligent investing is value investing. Calling something a value fund doesn't absolve it. You can call yourself a ballet dancer if you dance like me, but it is not a good thing. I wouldn't recommend people broadly invest with any value fund. I would avoid funds that have 100% turnover per year. It is a ridiculous way for an ordinary index fund to behave. It is imperfect, but best outcome for most know-nothings, in order to avoid being misled by fools and liars.

Q41: USD Currency. How many months would it take for exporters benefit?

I don't think USD weakness will fix trade deficit.

Q42: MN. Insurance and healthcare: How can we go about having best medical care at lowest cost? Also, could we get your book in schools?

A lot of people think existing system is all bad. People tire of dealing with dumb insurance companies. There may be some reality. Changes have been hard. If you look at hospital I am Chairman, we used to knife the kidney. Now we use lithoscripsy, with a 100% cure rate. I would argue our specialist doctor was one of greatest doctors Los Angeles ever had. I think there are good things in system as well as bad. It isn't clear how it will work out.

I do have one clear opinion. There is way too much intervention when dying. It is a national disgrace. They are way better at handling it in Europe than US. You can take pride in Europe at dealing realistically. We blow more money on stupid cases near death where no one is helped by the intensity of the interventions.

I have trouble getting my family to read my book.

Q43: US. Are we losing our competitive edge? Education failing, infrastructure falling down. Should corporations move abroad?

Some movement offshore for tax reasons is happening, and it hasn't ruined the country. It is the natural response to incentives. Berkshire could save a lot of money, but we just haven't done it. We have some companies in lower tax zones. But we pay enormous income taxes. There is a huge taxation claim between you and your money. We pay taxes

that are astronomical. I hope they become more astronomical. There is some development to shift around to save taxes.

Should be concerned if it gets big, but it isn't really big at the moment. Pharma co's make drugs in Puerto rico, etc etc.

Q44: CA. Insurance linked securities. Can you discuss insurance linked securities? Are they a threat to quality of underwriting?

Of course. Like slicing and dicing insurance risk – it wouldn't improve matters.

Q45: What has changed since you first started investing?

I owe a great deal to Mr Buffett. It took a while to convince me. Warren and I together got very good at reinsurance transactions and portfolio transfers. We've learned together at it. Berkshire would have been a mess if it had ever stopped learning. Only reason we've been able to keep a shred of decency in our record is that we have been hell bent to keep learning.

Q46: There is no shortage of well regarded financial experts about debt – equal to great depression?

Pushing credit hard makes me nervous. I know how countries got ahead, and it wasn't by pushing consumer credit to its extreme. I am not wild about the developments. But a great system will handle a fair amount of abuse. Some of the [credit] expansion was good. Do I like multiple credit cards being juggled? Do I look like kind of person who thinks that is good idea? It turns someone into a serf. You get customers just screwed together enough to pay you but who don't realize cost of 36% interest... I don't admire the guys who are good at acquiring the serfs.

Q47: Sweden. Why do you have so few followers?

From my point of view, we have too many damn followers. I don't think we have shortage of followers. Of course great bulk of people do things differently because people running the systems have incentives to do it differently. For a security to be mispriced, someone else must be a damn fool. It may be bad for world, but not bad for Berkshire.

Q48: Germany. What do you think of energy drink business and how to can you avoid a bad marriage?

I abuse caffeine, and I like soft drinks. I've never even tried an energy drink. There seems to be a growing market for it. Marriage: Ben Franklin gave best advice, keep your eyes wide open before marriage and half shut thereafter. [applause]

Q49: TX. You said at the Berkshire meeting that if there is inflation, Iscar would make a lot more money.

Iscar is selling to very professional customers who know a lot. They can just raise prices like some consumer goods. If I gave impression they would make a lot of money, I didn't make myself clear. Iscar is so good at delivering good products, it is hard for me to imagine them not selling more to customers who are making more money. They don't have automatic pricing power. But a price increase is a price increase.

Q50: In 2005 both Berkshire and Bill Gates bought NZD. What do you think now?

I don't have an opinion about NZ. Some things Warren does I just ignore. [laughter, pause] If I had something intelligent to say, I would say it.

Q51: Why the reluctance to own real estate?

Total real estate holdings are close to zero in the total enterprise. The Chairman has quirks. Old real estate purchases, at times we did borrow out equity in old real estate in order to reinvest it in Coca-cola and other things. We have huge surplus of cash now. But believe me we know all the tricks. We may behave differently in future.

Q52: Where would you sell an operating business?

We tend not to sell operating businesses. That is a lifestyle choice. We have bought well. We have a few which would be better if we sold them. But net we do better if we don't do gin rummy management, churning our portfolio. We want reputation as not being churners and flippers. Competitive advantage is being not a churner. Warren says, 'you should take high road since so much less crowded.'

Q: Amex Visa Mastercard. Can you compare these companies?

American Express has better customers, and we like that position, a lot.

Good friends – you are through another of our idiosyncratic meetings.

[standing applause]
Shai Dardashti

WESCO FINANCIAL CORPORATION

Annual Report 2008

Form 10-K Annual Report 2008

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated net "operating" income (i.e., before realized investment gains shown in the table below) for the calendar year 2008 decreased to $77,562,000 ($10.89 per share) from $93,405,000 ($13.12 per share) in the previous year.

Consolidated net income decreased to $82,116,000 ($11.53 per share) from $109,161,000 ($15.33 per share) in 2007. These figures included realized after-tax investment gains of $4,554,000 ($.64 per share) for 2008 and $15,756,000 ($2.21 per share) for 2007.

Wesco has four major subsidiaries: (1) Wesco-Financial Insurance Company ("Wes-FIC"), headquartered in Omaha and engaged principally in the reinsurance business, (2) The Kansas Bankers Surety Company ("Kansas Bankers"), owned by Wes-FIC and specializing in insurance products tailored to midwestern banks, (3) CORT Business Services Corporation ("CORT"), headquartered in Fairfax, Virginia and engaged principally in the furniture rental business, and (4) Precision Steel Warehouse, Inc. ("Precision Steel"), headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses.

Consolidated net income for the two years just ended breaks down as follows (in thousands except for per-share amounts)[(1)]:

	Year Ended			
	December 31, 2008		December 31, 2007	
	Amount	Per Wesco Share[(2)]	Amount	Per Wesco Share[(2)]
Wesco-Financial and Kansas Bankers insurance businesses —				
Underwriting gain (loss)	$ (2,942)	$ (.42)	$ 7,040	$ .99
Investment income	64,274	9.03	65,207	9.16
CORT furniture rental business	15,744	2.21	20,316	2.85
Precision Steel businesses	842	.12	915	.13
All other "normal" net operating earnings (loss)[(3)]	(356)	(.05)	(73)	(.01)
	77,562	10.89	93,405	13.12
Realized investment gains	4,554	.64	15,756	2.21
Wesco consolidated net income	$82,116	$11.53	$109,161	$15.33

(1) All figures are net of income taxes.

(2) Per-share data are based on 7,119,807 shares outstanding. Wesco has no dilutive capital stock equivalents.

(3) Represents income from ownership of the Wesco headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the insurance subsidiaries, less interest and other corporate expenses.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The foregoing supplementary breakdown is furnished because it is considered useful to shareholders. The total consolidated net income shown above is, of course, identical to the total in our audited financial statements.

Insurance Businesses

Consolidated operating earnings from insurance businesses represent the combination of the results of their insurance underwriting (premiums earned, less insurance losses, loss adjustment expenses and underwriting expenses) with their investment income. Following is a summary of these figures as they pertain to all insurance operations (in 000s).

	Year Ended December 31,	
	2008	2007
Premiums written	$316,472	$ 54,839
Premiums earned	$237,964	$ 54,411
Underwriting gain (loss)	$ (4,527)	$ 10,831
Dividend and interest income	84,920	89,716
Income before income taxes	80,393	100,547
Income taxes	19,061	28,300
Total operating income — insurance businesses	$ 61,332	$ 72,247

Following is a breakdown of premiums written (in 000s):

	2008	2007
Wes-FIC reinsurance —		
Swiss Re contract	$265,248	$ —
Aviation pools	33,374	35,346
Kansas Bankers primary insurance	17,850	19,493
Premiums written	$316,472	$ 54,839

Following is a breakdown of premiums earned (in 000s):

	2008	2007
Wes-FIC reinsurance —		
Swiss Re contract	$183,166	$ —
Aviation pools	34,418	34,998
Kansas Bankers primary insurance	20,380	19,413
Premiums earned	$237,964	$ 54,411

Following is a breakdown of after-tax results (in 000s):

	2008	2007
Underwriting gain (loss) —		
Wes-FIC reinsurance	$ (1,405)	$ 1,403
Kansas Bankers primary insurance	(1,537)	5,637
Underwriting gain (loss)	(2,942)	7,040
Net investment income	64,274	65,207
Total operating income — insurance businesses	$ 61,332	$ 72,247

As shown above, operating income includes significant net investment income, representing dividends and interest earned from marketable securities. However, operating income excludes after-tax investment gains of $4.6 million realized in 2008 and $15.8 million, in 2007. The discussion below will concentrate on insurance underwriting, not on the results from investments.

Wes-FIC engages in the reinsurance business. For several years, through yearend 2007, Wes-FIC's principal reinsurance activity consisted of only the participation in several pools managed by an insurance subsidiary of Berkshire Hathaway, Wesco's 80%-owning

parent. The arrangement became effective in 2001 and has covered hull, liability and workers' compensation exposures relating to the aviation industry, as follows: for 2006, to the extent of 12½% of the hull and liability pools and 5% of the workers' compensation pool; and, since 2007, 16.67% of the hull and liability pools and 5% of the workers' compensation pool. The Berkshire subsidiary provides a portion of the upper-level reinsurance protection to these aviation risk pools on terms that could result in the Berkshire subsidiary having a different interest from that of Wes-FIC under certain conditions, e.g., in settling a large loss.

At the beginning of 2008, Wes-FIC entered into a retrocession agreement with National Indemnity Company ("NICO"), another Berkshire Hathaway insurance subsidiary, for the assumption of 10% of NICO's 20% quota-share reinsurance of Swiss Reinsurance Company and its principal property-casualty affiliates ("Swiss Re"). Under this agreement, which was enthusiastically approved by Wesco's Board of Directors, Wes-FIC has assumed 2% of essentially all Swiss Re property-casualty risks incepting over the five-year period which began on January 1, 2008, on the same terms as NICO's agreement with Swiss Re. Wes-FIC's share of written and earned premiums under the contract for 2008 were $265.2 million and $183.2 million, representing a very significant increase in Wes-FIC's reinsurance activities to date. It is important to keep in mind that premiums assumed under the contract in each of the next four years could vary significantly depending on market conditions and opportunities.

It is the nature of even the finest property-casualty insurance businesses that in keeping their accounts they must estimate and deduct all future costs and losses from premiums already earned. Uncertainties inherent in this undertaking make financial statements more mere "best honest guesses" than is typically the case with accounts of non-insurance-writing corporations. And the reinsurance portion of the property-casualty insurance business, because it contains one or more extra links in the loss-reporting chain, usually creates more accounting uncertainty than in the non-reinsurance portion. Wesco shareholders should remain aware of the inherent imperfections of Wes-FIC's accounting, based as it is on forecasts of outcomes in many future years.

Wes-FIC's underwriting results have typically fluctuated from year to year, but have been satisfactory. When stated as a percentage, the sum of insurance losses, loss adjustment expenses and underwriting expenses, divided by premiums, gives the combined ratio. The combined ratios of Wes-FIC have been much better than average for insurers. Wes-FIC's combined ratios were 101.0% for 2008, 93.9% for 2007 and 94.0% for 2006. We try to create some underwriting gain as results are averaged out over many years. We expect this to become increasingly difficult.

Float is the term for money we hold temporarily, and, as long as our insurance underwriting results are break-even or better, it costs us nothing. We expect that the new business venture with NICO will significantly increase Wes-FIC's float, from its yearend 2008 balance of $164 million, thus providing additional opportunities for investment.

Kansas Bankers was purchased by Wes-FIC in 1996 for approximately $80 million in cash. Its tangible net worth now exceeds its acquisition price, and it has been a very satisfactory acquisition, reflecting the sound management of President Don Towle and his team.

Kansas Bankers was chartered in 1909 to underwrite deposit insurance for Kansas banks. Its offices are in Topeka, Kansas. Over the years its service has continued to adapt to the changing needs of the banking industry. Today its customer base, consisting mostly of small- and medium-sized community banks, is spread throughout 39 mainly Midwestern states. Kansas Bankers offers policies for crime insurance, check kiting fraud indemnification, Internet banking catastrophe theft insurance, Internet banking privacy liability insurance, directors and officers liability, bank employment practices, and bank insurance agents professional errors and omissions indemnity.

Because of recent events in the banking industry, including a number of bank failures, we are less confident in the long-term profitability of Kansas Bankers' long-established line of deposit guarantee bonds than previously. These bonds insure specific customer bank deposits above Federal insurance limits. After sustaining a loss of $4.7 million, after taxes, from a bank failure in the latter half of 2008, Kansas Bankers discontinued writing deposit guarantee bonds, and in September 2008 it began to exit this line of insurance as rapidly as feasible. The aggregate face amount of outstanding deposit guarantee bonds has been reduced, from $9.7 billion, insuring 1,671 institutions at September 30, 2008, to $3.4 billion, insuring 796 institutions at February 15, 2009, the first date that non-renewals and non-voluntary cancellations became effective. It is believed that few of the institutions Kansas Bankers insures are facing significant risk of failure. Because of aggregate limits as well as the purchase of reinsurance, the after-tax risk to Wesco from the failure of any single bank insured by Kansas Bankers is limited to a maximum of $7.6 million. Thus, we believe that Wesco's shareholders' equity is not significantly at risk as Kansas Bankers rapidly exits this line of insurance.

This decrease in exposure to loss, of course, will cause a sharp decline in Kansas Bankers' insurance volume, inasmuch as premiums from guarantee bonds not only approximated half of Kansas Bankers' written premiums for 2008, but also represented the entirety of the business it has recently conducted in 16 of the 39 states in which it is licensed to write insurance.

When Wesco purchased Kansas Bankers, it had been ceding almost half of its premium volume to reinsurers. In 2008 it reinsured only about 14%. And, because it has also restructured the layers of losses reinsured, it is now better protected from the downside risk of large losses. Effective in 2006, insurance subsidiaries of Berkshire Hathaway became KBS's sole reinsurers. Previously, an unaffiliated reinsurer was also involved. The increased volume of business retained comes, of course, with increased irregularity in the income stream. Kansas Bankers' combined ratios were 111.6% for 2008, 55.1% for 2007 and 73.8% for 2006. We continue to expect volatile but favorable long-term results from Kansas Bankers.

CORT Business Services Corporation ("CORT")

In February 2000, Wesco purchased CORT Business Services Corporation ("CORT") for $386 million in cash.

CORT is a very long-established company that is the country's leader in rentals of high-quality furniture that lessees have no intention of buying. In the trade, people call CORT's activity "rent-to-rent" to distinguish it from "lease-to-purchase" businesses that are, in essence, installment sellers of furniture.

However, just as Enterprise, as a rent-to-rent auto lessor in short-term arrangements, must be skilled in selling used cars, CORT must be and is skilled in selling used furniture.

CORT's revenues totaled $410 million for calendar 2008, versus $396 million for calendar 2007. Of these amounts, furniture rental revenues were $340 million and $327 million, furniture sales revenues were $62 million each year, and rental relocation revenues were $8 million and $7 million. CORT operated at after-tax profits of $15.7 million for 2008 and $20.3 million for 2007.

Since its acquisition, CORT has made several "tuck-in" acquisitions, most recently, the residential furniture rental division of Aaron Rents, Inc., and earlier in 2008, the establishment of international operations through the purchase of Roomservice Group, a small regional provider of rental furniture and relocation services in the United Kingdom, now doing business as CORT Business Services UK Ltd. CORT has also started up a nation-wide apartment locator service, originally intended mainly to supplement CORT's furniture rental business by providing apartment locator and ancillary services to relocating individuals. Paul Arnold, long CORT's star CEO, and his management team, have devoted much effort over the past two years, expanding and redirecting CORT's rental relocation services toward the needs of businesses and government agencies who require a skilled and able partner to provide comprehensive and seamless relocation services for the temporary relocation of employees worldwide.

CORT's operating results are subject to economic cycles. When we purchased CORT, its furniture rental business was rapidly growing, reflecting the strong U.S. economy, phenomenal business expansion and explosive growth of IPOs and the high-tech sector. Shortly thereafter, with the burst of the dot-com bubble, followed by the events of September 11 and a protracted slowdown in new business formation, CORT's operations were hammered, reflecting generally bad results in the "rent-to-rent" segment of the furniture rental business. There followed a far-too-short period of improving business conditions which have more recently given way to increasingly difficult recessionary conditions, perhaps the beginning of the worst economic recession in decades.

Under Wesco's ownership, CORT has continuously undertaken to improve its competitive position. With several websites, principally, www.cort.com and www.apartmentsearch.com, professionals in more than 80 domestic metropolitan markets, affiliates servicing more than 50 countries, almost twenty thousand apartment communities referring their tenants to CORT, many ancillary services, and its entrée to the business community as a Berkshire Hathaway company, CORT is better positioned than previously to benefit from an economic turnaround, certain to occur in due course. Near term, we expect more of the difficult business conditions of the recent past.

More details with respect to CORT are contained throughout this annual report, to which your careful attention is directed.

Precision Steel Warehouse, Inc. ("Precision Steel")

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, operated at after-tax profits of $0.8 million in 2008 and $0.9 million in 2007. These figures reflect after-tax LIFO inventory accounting adjustments decreasing after-tax income by $0.7 million for 2008 and $1.0 million for 2007. Precision Steel's operating results for 2008 also reflect the benefit of $0.2 million, after taxes, from the reversal of a portion of a provision for estimated expenses recorded in prior years in

connection with the environmental cleanup of an industrial park where a Precision Steel subsidiary has operated alongside approximately 15 other manufacturers for many years. Had it not been for the LIFO accounting adjustments or the benefit from the reversal of those environmental-related expenses, Precision Steel would have reported after-tax operating income of $1.3 million for 2008 and $1.9 million for 2007.

Precision Steel is continuing to suffer not only the ongoing effects of a long-term reduction in demand caused by customers' (or former customers') unsuccessful competition with manufacturers outside the United States and a trend towards smaller-sized orders, but also, the difficult effects from deepening recessionary conditions. In 2008, Precision Steel's service center volume was 37 million pounds, down from 39 million pounds in 2007 and 69 million pounds sold as recently as 1999. Volume for the fourth quarter of 2008 was only 6.2 million pounds, down 34% from the corresponding 2007 figure. Apart from the recessionary-caused weakness, the general and ongoing decline in Precision Steel's physical volume is a serious reverse, not likely to disappear in some "bounce back" effect once the economy recovers. Nor do we expect that ongoing price increases like the approximately 111% rise that has occurred since 1999, holding dollar volume roughly level despite a precipitous drop in physical volume, will continue.

We do not consider Precision Steel's recent after-tax operating earnings of approximately $1 million annually to be a satisfactory investment outcome, particularly when compared with its after-tax operating earnings which averaged $2.3 million for the years 1998 through 2000. And, because of the intensifying recession, more difficulty for Precision Steel will surely lie ahead.

Terry Piper, who became Precision Steel's President and Chief Executive Officer in 1999, has done an outstanding job in leading Precision Steel through very difficult years. But he has no magic wand with which to compensate for competitive losses among his best customers or from the deepening recession. He is undertaking the difficult task of paring costs to an endurable level.

Tag Ends from Savings and Loan Days

All that now remains outside Wes-FIC but within Wesco as a consequence of Wesco's former involvement with Mutual Savings, Wesco's long-held savings and loan subsidiary, is a small real estate subsidiary, MS Property Company, that holds tag ends of appreciated real estate assets consisting mainly of the nine-story commercial office building in downtown Pasadena, where Wesco is headquartered. Adjacent to that building is a parcel of land on which our construction of a multi-story luxury condominium building is almost complete. We are also seeking city approval of our plans to build another multi-story luxury condominium building, at a later date, on a vacant parcel of land in the next block. For more information, if you want a very-high-end condominium, simply phone Bob Sahm (626-585-6700). MS Property Company's results of operations, immaterial versus Wesco's present size, are included in the breakdown of earnings on page 1 within "other operating earnings."

Other Operating Earnings (Loss)

Other operating earnings (loss), net of interest paid and general corporate expenses, amounted to ($0.4 million) in 2008, versus ($0.1) million in 2007. The components of the $0.4 million of other operating loss in 2008 were (1) rents ($4.0 million gross in 2008) principally from Wesco's Pasadena office property (leased almost entirely to outsiders,

including Citibank as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiaries, less (3) general corporate expenses plus expenses involving tag-end real estate.

Consolidated Balance Sheet and Related Discussion

Strategically, we strive to invest in businesses that possess excellent economics, with able and honest management, at sensible prices. We prefer to invest a meaningful amount in each investee, resulting in concentration, exposing the portfolio to more significant market price fluctuations than might be the case were Wesco's investments more diversified. Concentration has worked out very well in the past as evidenced by significant realized investment gains. Details as to Wesco's investments can be found in Note 2 to the accompanying consolidated financial statements. Most equity investments are expected to be held for long periods of time; thus, we are not ordinarily troubled by short-term price volatility with respect to our investments provided that the underlying business, economic and management characteristics of the investees remain favorable. We strive to maintain much liquidity to provide a margin of safety against short-term equity price volatility.

Since the latter part of 2007, Wesco has invested $1.1 billion, at cost, in marketable equity securities, bringing the aggregate cost of Wesco's equity investments to $1.63 billion at yearend 2008, including an aggregate of $650 million, at cost, invested in the common stocks of Wells Fargo & Company and US Bancorp. The timing of our recent investments could not have been much worse. During 2008, several crises affecting the financial system and capital markets of the U.S. resulted in very large price declines in the general stock market, and in the banking sector, in particular, due significantly to the ongoing liquidity crisis as well as the deterioration of asset quality and earnings reported by the banking industry.

Wesco carries its investments at fair value, with unrealized appreciation or depreciation, after income tax effect, included as a component of shareholders' equity, and related deferred taxes included in income taxes payable, on its consolidated balance sheet. As indicated in the accompanying consolidated financial statements, Wesco's net worth, as accountants compute it under their conventions, decreased to $2.38 billion ($334 per Wesco share) at yearend 2008 from $2.53 billion ($356 per Wesco share) one year earlier. The principal cause of the decrease was the after-tax decline in fair value of Wesco's investments in marketable equity securities. As a result of further declines in fair values of these investments subsequent to yearend 2008, Wesco's shareholders' equity has further declined, by $303 million ($43 per share), through February 24, 2009.

The worldwide economy is currently suffering the effects of a deepening recession, perhaps the worst economic disaster since the Great Depression. We will not attempt to prognosticate the effects that Wesco will suffer or when the economy will recover, but we are certain that in due course, Wesco will prosper. In the mean time, Wesco's operations will bear their share of economic woes. We will continue to practice Ben Franklin's advice, that "a penny saved is a penny earned," as we trim expenses, albeit in higher denominations, to better endure the weakening economic conditions that surely lie ahead.

Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway. Moreover, the

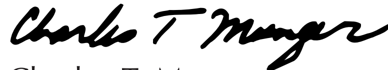
quality disparity in book value's intrinsic merits has, in recent years, continued to widen in favor of Berkshire Hathaway.

All that said, we make no attempt to appraise relative attractiveness for investment of Wesco versus Berkshire Hathaway stock at present stock-market quotations.

The Board of Directors recently increased Wesco's regular dividend from 38½ cents per share to 39½ cents per share, payable March 5, 2009, to shareholders of record as of the close of business on February 5, 2009.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Shareholders can access much Wesco information, including printed annual reports, earnings releases, SEC filings, and the websites of Wesco's subsidiaries and parent, Berkshire Hathaway, from Wesco's website: www.wescofinancial.com.



Charles T. Munger
Chairman of the Board
and President

February 25, 2009

WESCO ANNUAL MEETING MAY 6, 2009

(As is standard, no recording equipment was used to reproduce these notes. My high school typing teacher gets all the credit. As a result, these notes are recollections only – not quotes, and should not be relied upon. –PB)

CM: Welcome to the 2009 annual meeting of Wesco Financial. Directors please stand. If anyone present hasn't registered, please do so. This blue book is list of shareholders entitled to vote at the meeting and has been available for ten days at our offices. Our corporate secretary has a record that every shareholder was notified of the meeting. 7,119,807 shares outstanding. 97.5% proxied. Elections of directors. Motion to close. Motion is carried.

CM: We'll have a long question and answer session upon adjournment. Meeting is adjourned.

CM: We'll copy Berkshire this year in part. I'll ask a bunch of questions of myself and then I'll answer them. After you get tired of that we'll go to the audience.

Q1: CM: How serious is the present economic mess?

CM: Deadly serious, it is the worst mess since the Great Depression. The Great Depression caused Adolf Hitler to rise in a formerly civilized nation. You can't predict what happens when people get dissatisfied enough. We have a deadly serious problem, and it could lead to terrible problems.

Q2: CM: What caused the economic mess?

CM: It was a lollapalooza event – a confluence of causes, that is how complex systems work. All of the following helped:

1) Abusive practices in consumer credit. People who couldn't handle credit were deliberately seduced. People who did it justified it by saying competitors would do it if they didn't. That is not proper. Sometimes you should let others proceed and not copy them. It is abusive folly. I talked to a plastic surgeon last night who used to let people write checks against a line of credit on their house. Now his clients are finding those credit lines harder to get. A multiple credit card borrower is dangerous. He can look great right up until he goes bankrupt. Banks have abused their prerogatives and have stuck it in too hard. I have a fundamental theory that in some way the world is just, and if you do something immoral or stupid there will likely be a whirlwind someday where you get clobbered.
2) Mortgage brokers – often these are scum of the earth rejoicing in "rooking" the borrowers with flim-flam tricks, which often can happen with minorities in poor neighborhoods. On first and second mortgages – they built a huge balloon bound to create horrible mess, and the mess finally happened.
3) Wall Street went crazy. Any way of earning money short of armed robbery was ok. The last mortgage broker Merrill Lynch bought were a bunch of sleazy crooks even on the face of it. When people behave like that you get a tremendous mess.
4) Regulatory apparatus that allowed all this was also foolish. The regulators and legislators were in two categories. Legislators wanted poor people to have houses, but this is a bad idea since you want credit practices to be sound just like you want your engineering practices to be sound. People making money just rationalized what they did. Accounting systems spit it out as okay, even though in substance it wasn't right. It was ghastly and there was huge envy in the thing. If Joe made $3m, I'm better than Joe and so I deserve $3.5m.

5) Credit system was the repo system, one of best ways to grant unlimited credit ever invented. Then banks offered access to the repo system to hedge funds. It went to enormous excess. Some of it was due to democratic legislators hoping to help the poor, and some also was due to Republicans who overdosed on Ayn Rand. For Republicans, it was like legalizing armed robbery for anyone under 25. It was like letting the financial class prey on the poor. If it was unreasonable for the buyer, you got 9% for selling it. Ethos was of the "buyer beware". The vendors in America should care about selling good stuff to the customer.
6) Then the other issue was in terms of dizzy leverage on stock indices and CDS – where anyone could bet someone would go broke, even if they had no economic interest in the outcome. Then you could help that person along to ruin. We prohibited this in life insurance. I can't buy insurance if I don't have economic interest in the person (spouse, etc). These wise rules were thrown out in CDS markets. Then the people who did the accounting used mark to model. Both sides would allow profits. Anyone with engineering cast of mind will feel like throwing up into the aisle. Well go ahead, it will be a memorable moment if you do [laughter].
7) Accounting was phony because all the customers wanted it phony. Commissions were awesomely large, and it influenced people. And Greenspan was saying it was all for the best in the best of all possible worlds. To allow predatory class of people to do whatever they want to others is not like free enterprise at restaurants. The whole thing could go… back in September it was as if every bank deposit became unavailable – it looked like whole system would come crashing down last fall, and it accelerated downwards.
8) Luckily the government was awake, and was sensible enough to try to fix the situation. To fix it, we have to save the banks. That doesn't bother me, if you want perfections you don't live in this world. We had to save people who didn't deserve it, but it was important. It was smart government, taking over Fannie and Freddie and reducing mortgage costs. It was a correct decision.
9) Bank situation is much more complicated issue. The traditional way is you don't hear anything about the regulatory process, then you hear about the results after. There was no bake off – and that is a good system. The announced contest [*ed: the stress test*] makes me dubious, but it is better than nothing. Some banks should get more financing. Averaged out I would give Treasury Dept good marks, though I don't look forward to what they likely will do to WFC, since we own a lot. Their credit costs them so much less. Treasury are using a one size fits all. I would give WFC a flaming pass. But if it is a little unjust, maybe their duty is to take their medicine. When we have this much trouble, everyone shouldn't be screaming for the last iota. I think everything is working out fairly well. Much of what has been done has been done beautifully.

Q3: CM: What will be long term consequences of crisis for Wesco?

CM: Almost nothing. We are rich and well financed. By and large our businesses are gaining market share though the economic mess. That is the right way to run a corporation.

Q4: CM: What government response has been inappropriate?

CM: Ethanol is one of stupidest ideas invented by rational people. They don't count the fossil water or topsoil, and you don't get much more energy from it, and losing the safety net of cheap food so that food gets high priced is a monstrously stupid idea. People don't want to admit how stupid it is, but that inanity might pass. The other inanity is cap and trade. China spews out the most carbons, and they won't stop. Cap and trade would be a huge, massive interventionist tax. We don't need it. If everything is in one country, maybe you could cap and trade. But it is not.

What do we care about? Not using up the hydrocarbons of the world too fast. We do not have good substitute for fertilizers. Preserving those for later times is a good idea. So if we have a good idea why do we need a bad idea like cap and trade worldwide with a bunch of people who won't do it?

How do we solve it? We have to use the energy of the sun. I don't think we want everyone to have nuclear plants. So we should harness the energy of the sun, and we should cover the nation with an efficient power grid. Then we shift cars to battery propulsion. We know how to create the grid, we understand that already. Getting solar down 50% in price will probably happen. Freeman Dyson is smart man, and he thinks energy cost is 5% more or less for whole world. Listen more to Dyson, less to Al Gore. One knows how to think, one doesn't. Chinese create the most coal plants, and they are choking to death in their cities. Chinese are logically located to gain enormously and markedly in manufacturing solar. If we want them to get rid of brown coal, then it would be wonderful if they can gallop to leadership in harnessing the energy of the sun. My mind drifts in the direction of photovoltaic, rather than to solar thermal. If they last a long time - good, and prices are likely to come down.

And we need the stimulus of a big energy grid. We have intelligent things to do with the money. Clean power -- that is what we should do. We need the stimulus. The cost saving doesn't matter, but still think it will come. I think we can adapt to a world with more electricity. Israel is interesting place. Half of water used in Israel is from the sea, they take salt from seawater. When mankind does that on huge scale… think of the benefits. But a huge desert with endless power from the sea, maybe everyone there in Middle East can get along better when they collaborate on a large engineering solution. Wang Chuanfu will you stand [*ed: CEO of BYD*]? He is on his way. I am pleased that the world has the capacity I foresee. I think building a big grid is a good idea. I'm not into systems on everyone's garage. I'd rather utilities worked out the scale issues, so that whatever you need just comes. Utilities need time shifting of power, so better battery technology is important. We need it in a car since lithium is a light element. I'm told that lithium is very efficient in amount of charging and discharging, and other elements are all cheap. The sea contains lithium - lithium mines are old sea beds. To me these are ABC, every bright high school student should be nodding his head. Though I'm not sure I'm having same effect. [laughter]

If one enables Arabs and Israelis to live together, cheap power would be very good. It is exactly what should happen, and it will happen. If seas rise a little bit, we can handle it. In Holland, much of the country lives below sea level. We have Nervous Nellies, and they enjoy being the town the crier of misery. Correct cry is "plenty", not misery. That lithium powered car in Omaha, the amount of torque in an electric car is something – the tires would squeal if you pressed to hard.

You need economic action. What is big risk using unemployed people to build big electricity grid? And we need to change our laws so that festering blobs of local policy making can be overridden. You may not like Chinese, but when they need to do something THEY DO IT. India has too much due process, they copied England, and it was not a good idea. Some places have sacred cows, can't fix the traffic due to the cows downtown. We need some amendments to our religious ideas. That said, in big scale of things, there is a lot to be cheerful about.

Q5: CM How fast will improvements come?

CM: We have some sober facts. Japan had boom, and they put full resources of government into fixing it. But they got stasis, not growth. They spent an immense amount of money, and they got only stasis. That would be terrible here, and we have way more trouble. I would predict that it

would very awkward to have no GDP growth per capita in USA. No economist in world predicted it for Japan 10 yrs ago. I think Japan is an interesting and threatening example. I don't know if we will do better. Japan stimulus was worthless in some ways, every pothole got filled 3 times. They didn't do highly useful things. If we create a big electric grid I think that is best way to go. I have never taken a course in economics, and here I am speaking about Japan. I'm not apologizing. I'm trying to do it my own way.

Q6: CM: Current stock prices?

CM: Warren said this weekend that the best year he ever had was a recession when economy going down and stocks were going straight up. If you wait, you'll miss it. I'm willing to buy common stocks at current prices with long term money. Coca-Cola and WFC I would buy today. I wouldn't expect miracles – no doublings. Anyone who promises miracles should be shown the door. If it promises high rates of return and has high commissions don't read it. You shouldn't wait for agony to be over before buying common stocks. I for myself am pretty well invested. If there is a big bottom out there, I'm going to miss it. All these things are pretty obvious. I think we are lucky in that we have a stimulus. There is a way of doing this [*ed: electrical grid investment*]. I have been quoted figures of 7-8% of power losses in big systems over long distances. I don't think we ought to care we are leaving it. Iowa – 20% of electricity is from wind. All kinds of things can be done.

Q7: CM: Big issue – what kind of re-regulation should come to financial industry?

CM: I don't know why something that can't fail should be allowed to be anything other than a pretty boring business. That is what it used to be. Partners didn't make a ton of money, and they were quite conservative. They were old fashioned, they had seen the 1930s. We don't need a system where every bright young man needs $8bil to play with financed daily in the repo market. I think we should take away all the activities that aren't boring. They should do moderate things, stock-broking, etc. That doesn't take a huge amount of capital and does not present huge dangers. If someone wants to go crazy, I would close the system for him too. Massive leverage is bad. We don't need options exchanges which have made margin rules uncontrollable. We don't need credit default swaps. If someone wants to be gamey, he can operate as a hedge fund, and take in only sophisticated investors. But I would not reward the ballooning of the operations. A man does not deserve a lot of pay because he balloons a balance sheet at a tiny spread. An idiot can do it, and many do. But you can imagine how many would scream in London and NY. But if I were a despot, that is what I would do. I would run like Singapore. I wouldn't run a world with 10-15% of engineers trying to make money by outsmarting other people. What purpose does this serve? The world worked fine in the 1950s. Obama intends to reduce the power of NYC, and I admire him for saying it. I don't think he'll have guts to reduce it as much as I would. We'll see. Do you really need to announce to friends at country club that daughter marrying a hedge fund professional, and this is the highest rung? It is not pretty to take money away from people because you are a better card player than they are, and can lure them into the game and take a croupier fee. We need to protect the body politic, and it would be constrictive at start. [Wolfenhouer] is an economist I like a lot, he thinks like me.

Q8: CM: Berkshire vs Wesco?

CM: Berkshire is better. Wesco sells too high because you people are cultists. If I were buying today, I'd buy Berkshire. That is the place the entrepreneurs want to join. Berkshire is where people want to be. It is a historical accident that Wesco is independent.

[Munger now invites several attending journalists to ask questions.]

Q9: Mattias Schwartz from Harpers Magazine. You talked about what you would do if you were President. What would you do if you were Sec of Treasury?

CM: I think they have been doing pretty well. I agree with Hank Paulson and his work on the toxic asset scheme. That said, it was not nearly strong enough. I think he deserves credit for changing his opinion/adapting as facts changed. Geithner and Summers are very good. They are terribly constrained by the politics of their locale. You know what should be done, but can't get it done under the constraints of politics. I never had interest in Government. I wouldn't want to be prominent with someone pounding on my head with two hands tied behind my back.

Q10: Buck Hazel, Motley Fool. What would you do…?

CM: I would reduce incentives to go to Wall Street. I would make Wall Street purposely less efficient. I would invest in the electric grid, and I would change laws so little hamlets couldn't reject rational action. I would go hell for leather for electric grid and electric cars.

Q10: Car incentives?

CM: Toyota has a problem in the world I forsee. Detroit will have a hell of a problem when Toyota has a problem. To solve Detroit, I would throw out all the contracts, and let one company take only what they want [from the factories and models and dealers], and abandon the rest. That would have a 40% chance of working. The same thing happened with British Leland, and after billions of pounds, it didn't work. These people haven't covered themselves with glory. There is nothing in this crowd that makes me feel the way I feel about some of other people that are bringing the new world in a rational way. I remember when Rochester had two of the best companies in world, Xerox and Kodak. Is this end of world now, now that someone else is winning? They have great medical centers and nice cheap houses. It is unthinkable that any geographic area shouldn't lose what it formerly enjoyed. It is natural that some places go down while others rise in capitalism. If someone my age can cheerfully die, some geographic area can see its main industry shrink.

Q11: Cathy Kristoff. In the last year individual investors, have become disillusioned, believing now that Wall Street is corrupt. They worry that they shouldn't trust corporate stocks. Hundreds of shareholders have said I've sold out of stocks, citing Ponzi schemes, and exorbitant pay.

CM: First, everyone should maximize their social security benefit. What to do if you have investable sums? I think to expect a lot is irrational. In other words, you are likely to be happier if you are aiming low. The right way to get felicity is by aiming low. Not many can get felicity by aiming high. Having realistic expectations is important. You should defer consumption, and do some investing. Now stockbrokers in this room are smart, but they aren't normal. In general stock brokers are a disaster waiting to happen.

Q12: Are shareholders being robbed, or is it a misperception?

CM: It is in nature of stockmarkets that they go down. So people suffer then. Conservative investing and steady saving without expecting miracles is the way to go. Some people in this room can figure out how to average twice the rate of return. I can't teach everyone else to do it. It is pretty difficult.

Q13: Charlie, [Gurustocks.com]. Lots of investors lost 30% last year. What should we do to avoid those losses in future, or should we live with it?

CM: I don't have a system to avoid downmarkets. If anyone told me he could skip the downmarkets and catch the upmarkets, I'd throw him out. If you aren't suffering a little right now, you haven't lived your life right.

Q14: Paul Larsen, Morningstar. Investment books you would recommend? We didn't get any books on Saturday.

CM: <u>Outliers</u>, by Malcolm Gladwell. It is a terrific book, a bestseller. There is a reason why it is a best seller. The guy has a way of picking out examples that guide reason well. I tend not to read self-help investment books. Like soap operas, I know the plots.

Q15: Kim Voss, Berkshire shareholder. Inflation is coming. How to hedge?

CM: I remember 2c stamps, 5c hamburgers, and the minimum wage of 30c / hr. In 80 yrs since those prices, there has been lots of inflation. Did it ruin investment opportunities? No. It isn't easy, there are always huge risks, and of course there will be inflation. It was a miracle between 1860 and 1910 there was no inflation. For a long time the country got ahead without inflation. That world is not coming back.

Q16: Melbourne, AU. Is Berkshire doing anything to protect against inflation?

CM: Berkshire is aware that inflation is the long term way of the world. We try to do the best we can. We bought utility bonds to yield 9 or 10%. What about inflation, you might ask? Well, government bonds are yielding 3%, so 9% isn't bad. We don't have one size fits all.

Q17: NYC. You have spoken out against Wall Street and executive compensation. How do you justify your investment in Goldman Sachs?

CM: We thought their merits outweighed their defects. We don't expect perfection.

Q18: Vinesh, CA. What about the commercial real estate disruption and GE Capital?

CM: They will lose some money.

Q19: Palo Alto, CA. Coca-Cola company. Neville Isdell and Mukthar Kent appear successful right now. Why?

CM: I think current CEO will likely to be an exceptionally gifted CEO. Coke has a strong position in the world, and when run by a strong CEO the results will be good.

Q20: How will WFC business model look different going forward?

CM: I think they are pretty well located. I think their culture is well-adapted. I think WFC has bright prospects. I wouldn't be surprised if we had more regulation. I think raising people's interest rates on credit cards – well, that infuriates people. Banks will have to behave better, and should not be totally unregulated.

Q21: Berkshire. Executive leadership – can you teach great qualities in leaders, or is it innate?

CM: Some people are more teachable than others, and the same is true of dogs. I wish you lots of luck if trying to win the prize with an unteachable dog, or human. Capitalism filters out people who don't do well, and replaces them. Think of golf, it is a tough meritocracy. I like it that way, think of the talent we get to watch! I first look for trust, regardless of talent. First you need trust and then good judgment. Warren talks about IQ130, that they have all they need. But if people have enough sense to operate in field of competency, you can do very well. It is the overreaching, the crazy overconfidence that does in so many people. And salesmen are very sophisticated. I saw a REIT prospectus recently -- I don't see how anyone could read the prospectus and buy it. But there was a big commission for the salesman. Throw it in wastebasket. You don't have to smart to do this.

Q22. CA. Renewable energy lessons, thank you. India and china – how is the long term investment climate in India vs China?

CM: I think Wang Chuanfu will do amazingly well in China. He has the right discipline and personal attributes. I wouldn't personally choose to spend my life competing with Wang Chuanfu -- there must be easier people to compete with. I think he wants to make a contribution to civilization. I wish I could live longer so I could watch, as he is almost sure to succeed. I may be wrong, we will see. I think he will succeed because he deserves to succeed.

Q23: I always have tough time balancing short term and long term decisions. Right now I will take any customer and investor – because I am starting a new business.

CM: I don't try to back start-up businesses. There were already huge achievements at BYD by time I decided to back them. I don't do startups because I have found a way that is easier for me.

Q24: Why is growth so important. Everyone is obsessed, are there any limits?

CM: There are limits to growth, you can't have infinite growth of finite goods.

Q25: St. Louis, railroad investments. Pricing power in railroads may be at risk, and coal volumes may be at risk. What would you change your view on railroads?

CM: If we stopped using coal it would be bad for railroads. I think there will be a lot of freight still. They now have a competitive advantage over trucks. But it will be more foolproof if we didn't rush into an electric grid.

Q26: San Francisco. National electric grid planner – how long would you spend on engineering?

CM: We understand the technology. I don't have a good feeling for timetables. The Chinese don't fool around, but in other places it takes forever. We would need a streamlining process to do it. We had streamlining processes on natural gas pipelines, and look at how well they work. I have no feeling that it isn't perfectly [*ed: within reach*].

Q27: Tilson. Newspapers portrayed you as negative this weekend, but I heard different meeting.

CM: I think our utility operation is as good as any in the country. I would imagine that if a better grid comes Berkshire will be heavily engaged in it. It would be a waste to not use the managers of our energy subsidiary. They try to deliver what they would want if they were the regulator.

We almost bought Constellation Energy -- that would have been immense. It blew up, but with substantial profit to Berkshire.

Q28: Florida. Do you have any recent fresh ideas on human misjudgment or cognitive errors?

CM: Misjudgment is like sunshine, it will always be part of the world. Many of the misjudgments will be massive. We have misjudgment too at Berkshire, but we have less than others. If you can stay high in the pack, you'll do well. Best chapter in Outliers was about people with an IQ of 200 who failed utterly in life. If you can't learn from that chapter, I don't want to bet on you. I don't know Gladwell but I was flabbergasted – it was a marvelous book. It gives you an insight into what you might call fate. It is good to know how fate will rule your odds.

Q29: CA. Oil production?

CM: Ultimately we will produce oil at lower levels. We are near peak oil production now. The interesting one is natural gas. We have found a lot of good natural gas, and it has surprised everyone.

Q29a: *Any thoughts on upper threshold?*

CM: World will adapt to whatever the price of oil is, because it will have to. I don't think it is the end of the world if prices go up.

Q30: A few years ago I met Phil Fischer, and he said the right answer wasn't right, that is was better to ask the right questions. What questions should we be asking?

CM: I don't think we know how this will all play out. What are the odds of a hostile weapon being used in next 30 years? Pretty high, I'd wager. I think you have to think over all the possibilities. I don't think it is a big deal. I was in Japan a year ago. It is civilized place with static GDP, and it is not a disaster. Mono-ethnic populations can get along better than diverse ones.

Q31: Municipal bonds?

CM: I don't think I want Berkshire to insure an endless amount of municipal bonds. They have good credit rating, but I don't think they always will. I think politicians, if they can throw it to bond insurer, they will.

Q32: Geico- Advertising spend of $800m, on the weekend you suggested this represented approximately 100m for maintenance capex, and 700m for growth capex – is this right?

CM: That is correct.

Q32a: Snowball, what did you think?

CM: Snowball is an interesting book covering a single life in such detail. That said, some facts will be incorrect. And she made a lot of money for herself.

Q33: CA. Reverse mortgages?

CM: They make sense in some ways, but they tend to have big commissions. With old people with problems, so I am leery of it. I don't say they shouldn't exist, but I am leery of anything with a commission and sold to the old.

Q34: Las Vegas. Berkshire has evolved into institution of learning. On Saturday you began to talk about how Berkshire would have effects on civilization after you both are gone. Could you elaborate? Have you or Warren documented your decision-making process?

CM: Berkshire model is so different from standard model that it has had only modest effect/copycats. There was a surgeon once who invented a very difficult surgery. Many saw it and said 'I won't do it – it's too hard'. Many think we are nuts. Ben Franklin's last recommendation to the Constitutional Convention was that government workers not be made a permanent professional class. I love that idea. There is a wise saying, 'There should be no man fit to hold public office who isn't perfectly willing to leave public office at any time." We don't pay directors anything, they all own lots of stock. They are wise. No one at Berkshire needs his director's fee. Normal corporations pay $250k per year, and that is a lot of money to a college professor. But corporations of America would be better run if directors were unpaid. [clapping] You clap, but that idea is not spreading like wildfire. And I think Franklin was right. I think unpaid University Trustees are a good system. I think Walmart may be more important than Harvard. These are very important places. Who has the power is very important. If you stop to think about it, it is interesting to be a director, to interface with good people to solve good problems? Why should they want a lot of pay? We self-select for people who want a lot of pay, and I'm not sure that is best way to do it. If you like it, you carry the torch.

Q35: Is investing in a paper company that supplies central banks a good idea?

CM: Because you have identified the problem, doesn't mean that is right for you. If you bought real estate for inflation, it went down. The nature of game is that it is hard. My son knew a man with a nice house. He had USD1m of securities. He was living in his house free and clear. But he felt he didn't have enough. He sold puts on tech stocks in 2000. He lost his house and assets, and now works in a restaurant. Stretching to reach sacred needs is difficult. Needs should not be sacred. People who can handle credit and have discipline, they are the people I like. Sometimes salespeople love a second pair of shoes, and soon they start cheating someone to have a better life.

Q36: De-inflationary environment?

CM: I don't think every asset class and every region is the same. Now with interest rates at 4.5%, if I had good credit in Omaha I would buy a house in Omaha. But in other places there is more horror still to come. You have to make these judgments all the time. We have submarkets everywhere and they are quite different. Pasadena houses are high priced. But it is run well, there are talented politicians. But I'd probably buy now in Pasadena. Though I might buy at foreclosure…

Q37: Have you read man who loved china, by Ogilvy …. Obviously you have great interest in China. Why did China cease to being a leader in the world?

CM: Because there was a dumb self-satisfied emperor followed by a self-selecting group of Confucian bureaucrats. It got to be like French literature at Yale, it's nutty. But now I think they get it.

Q38: It is also a huge population base with a huge pool of latent talent. Do you find something unique in China?

CM: I like Confucianism, and it pays attention to elderly males, and the love of learning, and their family mindedness. Wang Chuanfu – where will he get $300k to start his company? Well, he had a cousin. The cousin had an ethos – and out comes the $300k. I like Confucianism, I like work ethic, I like that rising leaders are engineers – that is my kind of communist. It is a great nuclear power. We'd be crazy not to get along with China, and they would be crazy not to be friendly to us. I think culture and genetics work together. There is a theory that the Chinese got talented because growing rice takes high IQs. That is not politically correct by the way. Somebody said rice growing regions smarter. I don't know if true.

Q39: David Winters. Is AIG still mispricing risk?

CM: These are sad days at AIG. They have lost some of their position. It does not help to be headlines, when you are selling insurance and people need to trust the insurance. AIG has been very unlucky. They have had difficult hand to play. That could happen to Berkshire. It happened to China – it is easy to fall backwards. It is hard to go forward. It is particularly hard when your children are raised in affluence and the Imperial Guard at headquarters gets to thinking they are the cats meow. We don't want to deny our children anything. We would like it more if children were more disciplined and ambitious. If you take every leading civilization, they have all passed it on to someone else. Where is Egypt or Athens or London? It is nature of things that we do baton passing. It is state of nature that baton gets passed, to someone who tries harder and cares more.

Q40: Student in Amsterdam. Having CAPM arguments with professors.

CM: Future of finance? By and large I don't think too much of finance professors. It is a field with witchcraft. I think a lot of physics and engineering professors. They try to teach it like physics, but it doesn't yield to that. I never went to university with finance professors. Finance professors all believe in diversification, while we try to beat the average. If you buy a dob of everything, that is different than buying something you know something about. That is a different fountain than I want to drink in.

Q41: How do you get a feeling for managers trustworthiness?

CM: There isn't a single formula. You need to know a lot about business and human nature and the numbers. How would you read bone tumor slides? Nobody is any good who hasn't been doing it for years. It is unreasonable to expect that there is a magic system that will do it for you.

Q42: Capetown SA. You point to crazy fees and commissions, what about expensive lawyers?

CM: Cost is too high and education is imperfect. If you go to law school, it is a good place to find a mate. Big firms have gotten too prosperous and there is too much paperwork, and not enough good sense. If I were running a law firm, I would cull one client a year on moral grounds. My partners refused, they were afraid it would be there first client. One of my early business successes was firing most of my customers. We were making transformers, and purchasing agents wouldn't let us make any money. We shrank the business and we returned to a nice profit. There are some customers you don't want. Peter Kauffman is here, he tries to get his suppliers to make money. That is win win. I think a huge mistake to try to rip off suppliers. Whether they are lawyers or others, it is okay for them to make money.

Q43: Newspaper companies, potential? CA taxfree bond market?

CM: The ordinary daily newspaper will perish. Maybe they will find a model a lot like public broadcasting, where they get a few people to pay a good price. But microeconomics of newspapers not a great place to invest money. CA bonds? I believe the rating is the worst in the country, slightly worse than Mississippi's. Gerrymandered legislature with certified nuts on right and left hate each other. It is a very serious problem and big mess. You can't just assume good will win. Sometimes evil wins, and that may happen in legislature for some time. Deliver to others the kind of service you would want yourself. It is such a simple idea.

Q44: US trade deficit. Unsustainability? Decline in USD not enough?

CM: Strange things happen that after 20 yrs of labor governments in UK that Thatcher would come along and change things around. Warren is more pessimistic than I am. China is prospering enormously taking our paper, and they are gaining market position by doing so. If it doesn't show up in equations of economists, they aren't using right equations. Deflation on securities is small price to pay for a civilization growing at 8%. I think China doing things amazingly well.

OK, We'll go to the director's meeting.   [4:08pm – early!]

WESCO FINANCIAL CORPORATION

Annual Report 2009

Form 10-K Annual Report 2009

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated net "operating" income (i.e., before realized investment gains shown in the table below) for the calendar year 2009 decreased to $54,073,000 ($7.59 per share) from $77,562,000 ($10.89 per share) in the previous year.

Consolidated net income decreased to $54,073,000 ($7.59 per share) from $82,116,000 ($11.53 per share) in 2008. The 2008 figure included realized after-tax investment gains of $4,554,000 ($.64 per share). No investment gains or losses were realized in 2009.

Wesco has four major subsidiaries: (1) Wesco-Financial Insurance Company ("Wes-FIC"), headquartered in Omaha and engaged principally in the reinsurance business, (2) The Kansas Bankers Surety Company ("Kansas Bankers"), owned by Wes-FIC and specializing in insurance products tailored to Midwestern community banks, (3) CORT Business Services Corporation ("CORT"), headquartered in Fairfax, Virginia and engaged principally in the furniture rental business, and (4) Precision Steel Warehouse, Inc. ("Precision Steel"), headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses.

Consolidated net income for the two years just ended breaks down as follows (in thousands except for per-share amounts)[1]:

	Year Ended			
	December 31, 2009		December 31, 2008	
	Amount	Per Wesco Share[2]	Amount	Per Wesco Share[2]
Wesco-Financial and Kansas Bankers insurance businesses —				
Underwriting gain (loss)	$ 7,222	$1.01	$ (2,942)	$ (.42)
Investment income	55,781	7.83	64,274	9.03
CORT furniture rental business	(1,359)	(.19)	15,744	2.21
Precision Steel businesses	(648)	(.09)	842	.12
All other "normal" net operating earnings (loss)[3]	(6,923)	(.97)	(356)	(.05)
	54,073	7.59	77,562	10.89
Realized investment gains	—	—	4,554	.64
Wesco consolidated net income	$54,073	$7.59	$82,116	$11.53

(1) All figures are net of income taxes.

(2) Per-share data are based on 7,119,807 shares outstanding. Wesco has no dilutive capital stock equivalents.

(3) Includes income from ownership of the Wesco headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the insurance subsidiaries, less interest and other corporate expenses, and, in 2009, a $6.2 million (after taxes) writedown of real estate held for sale.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The foregoing supplementary breakdown is furnished because it is considered useful to shareholders. The total consolidated net income shown above is, of course, identical to the total in our audited financial statements.

Insurance Businesses

Consolidated operating earnings from insurance businesses represent the combination of the results of their insurance underwriting (premiums earned, less insurance losses, loss adjustment expenses and underwriting expenses) with their investment income. Following is a summary of these figures as they pertain to all insurance operations (in 000s).

	Year Ended December 31,	
	2009	2008
Premiums written	$339,191	$316,472
Premiums earned	$323,221	$237,964
Underwriting gain (loss)	$ 11,111	$ (4,527)
Dividend and interest income	67,049	84,920
Income before income taxes	78,160	80,393
Income taxes	15,157	19,061
Total operating income — insurance businesses	$ 63,003	$ 61,332

Following is a breakdown of premiums written (in 000s):

	2009	2008
Wes-FIC reinsurance —		
Swiss Re contract	$294,142	$265,248
Aviation pools	35,085	33,374
Kansas Bankers primary insurance	9,964	17,850
Premiums written	$339,191	$316,472

Following is a breakdown of premiums earned (in 000s):

	2009	2008
Wes-FIC reinsurance —		
Swiss Re contract	$276,681	$183,166
Aviation pools	34,463	34,418
Kansas Bankers primary insurance	12,077	20,380
Premiums earned	$323,221	$237,964

Following is a breakdown of after-tax results (in 000s):

	2009	2008
Underwriting gain (loss) —		
Wes-FIC reinsurance	$ 10,379	$ (1,405)
Kansas Bankers primary insurance	(3,157)	(1,537)
Underwriting gain (loss)	7,222	(2,942)
Net investment income	55,781	64,274
Total operating income — insurance businesses	$ 63,003	$ 61,332

As shown above, operating income includes significant net investment income, representing dividends and interest earned from marketable securities. However, operating income excludes after-tax investment gains of $4.6 million realized in 2008. The discussion below will concentrate on insurance underwriting, not on the results from investments.

Wes-FIC engages in the reinsurance business. At the beginning of 2008, it entered into a retrocession agreement with National Indemnity Company ("NICO"), an insurance subsidiary of Berkshire Hathaway, Wesco's 80%-owning parent. Under the contract, Wes-FIC has assumed 10% of NICO's 20% quota-share reinsurance of Swiss Reinsurance Company and its

principal property-casualty affiliates ("Swiss Re"). Under this agreement, which was enthusiastically approved by Wesco's Board of Directors, Wes-FIC assumed 2% of essentially all Swiss Re property-casualty risks incepting over the five-year period which began on January 1, 2008, on the same terms as NICO's agreement with Swiss Re. Wes-FIC's share of written and earned premiums under the contract were $294.1 million and $276.7 million for 2009 and $265.2 million and $183.2 million for 2008, representing very significant increases in Wes-FIC's reinsurance activities. It is important to keep in mind that premiums assumed under the contract in each of the next three years could vary significantly depending on market conditions and opportunities.

For several years, through yearend 2007, Wes-FIC's principal reinsurance activity consisted only of its participation in several pools managed by a subsidiary of General Reinsurance Corporation ("Gen Re"), another insurance subsidiary of Berkshire Hathaway. The arrangement became effective in 2001 and has covered domestic hull, liability and workers' compensation exposures relating to the aviation industry. For the past three years, Wes-FIC has reinsured 16.67% of the hull and liability pools and 5% of the workers' compensation pool. Since mid-2009 Wes-FIC has also been reinsuring 25% of an international hull and liability pool. Another subsidiary of Gen Re provides a portion of the upper-level reinsurance protection to these aviation risk pools on terms that could result in the Berkshire subsidiary having a different interest from that of Wes-FIC under certain conditions, e.g., in settling a large loss. Premium volume under these pools has approximated $35 million annually.

It is the nature of even the finest property-casualty insurance businesses that in keeping their accounts they must estimate and deduct all future costs and losses from premiums already earned. Uncertainties inherent in this undertaking make financial statements more mere "best honest guesses" than is typically the case with accounts of non-insurance-writing corporations. And the reinsurance portion of the property-casualty insurance business, because it contains one or more extra links in the loss-reporting chain, usually creates more accounting uncertainty than the non-reinsurance portion. Wesco shareholders should remain aware of the inherent imperfections of Wes-FIC's financial reporting, based as it is on forecasts of outcomes over many future years.

Wes-FIC's underwriting results have typically fluctuated from year to year, but have been satisfactory. When stated as a percentage, the sum of insurance losses, loss adjustment expenses and underwriting expenses, divided by premiums, gives the combined ratio. Wes-FIC's combined ratios from reinsurance activities were 94.9% for 2009, 101.0% for 2008 and 93.9% for 2007, much better than average for insurers. We try to create some underwriting gain as results are averaged out over many years. We expect this to become increasingly difficult.

Float is the term for money we hold temporarily. Its major components are unpaid losses and unearned premiums, less premiums and reinsurance receivable, and deferred policy acquisition costs. As long as our insurance underwriting results are break-even or better, float costs us nothing. The new Swiss Re venture with NICO has significantly increased Wes-FIC's float, from $76 million at the end of 2007, to $264 million at yearend 2009, thus providing additional opportunities for investment. We hope to see our float continue to increase, but we make no predictions.

Kansas Bankers was purchased by Wes-FIC in 1996 for approximately $80 million in cash. Its tangible net worth now exceeds its acquisition price, and it has been a very satisfactory acquisition, reflecting the sound management of President Don Towle and his team.

Kansas Bankers was chartered in 1909 to underwrite deposit insurance for Kansas banks. Its offices are in Topeka, Kansas. Over the years its service has continued to adapt to the changing needs of the banking industry. Today its customer base, consisting mostly of small- and medium-sized community banks, is spread throughout 29 mainly Midwestern states. Kansas Bankers offers policies for crime insurance, check kiting fraud indemnification, Internet banking catastrophe theft insurance, Internet banking privacy liability insurance, directors and officers liability, bank employment practices, and bank insurance agents professional errors and omissions indemnity.

Last year we reported that events in the banking industry, including a number of bank failures, caused us to become less confident in the long-term profitability of Kansas Bankers' long-established line of deposit guarantee bonds. These bonds insure specific customer bank deposits above Federal insurance limits. After sustaining a loss of $4.7 million, after taxes, from a bank failure in the latter half of 2008, Kansas Bankers discontinued writing deposit guarantee bonds, and in September 2008 it began to exit this line of insurance as rapidly as feasible. The aggregate face amount of outstanding deposit guarantee bonds has been reduced, from $9.7 billion, insuring 1,671 institutions at September 30, 2008, to $33 million, insuring 10 institutions, currently. We believe that none of the banks whose deposits are currently insured are facing significant risk of failure.

This decrease in exposure to loss, of course, has caused a sharp decline in Kansas Bankers' insurance volume, inasmuch as premiums from guarantee bonds not only approximated half of Kansas Bankers' written premiums for 2008, but also represented the entirety of the business it had conducted in almost half of the states in which it was licensed to write insurance in 2008. The insurance business is highly competitive, with lengthy periods during which competitors offer coverages at prices we do not consider adequate. Kansas Bankers is now licensed to sell insurance in 29 states, down from 39 states one year earlier, with plans soon to withdraw from 4 more. We expect that Kansas Bankers will ultimately expand its premium volume, at prices deemed satisfactory.

When Wesco purchased Kansas Bankers, it had been ceding almost half of its premium volume to reinsurers. In 2009 it reinsured only about 1%. And, because it has also restructured the layers of losses reinsured, it is now better protected from the downside risk of large losses. Effective in 2006, insurance subsidiaries of Berkshire Hathaway became KBS's sole reinsurers. Previously, an unaffiliated reinsurer was also involved. The increased volume of business retained comes, of course, with increased irregularity in the income stream. Kansas Bankers' combined ratios were 140.2% for 2009, 111.6% for 2008 and 55.1% for 2007. Kansas Bankers' business activities require a base of operations supported by significant fixed operating costs which do not lend themselves to downsizing in proportion to the recent decline in premium volume. We continue to expect volatile but favorable long-term results from the now much smaller business remaining in Kansas Bankers.

CORT Business Services Corporation ("CORT")

In February 2000, Wesco purchased CORT Business Services Corporation ("CORT") for $386 million in cash.

CORT is a very long-established company that is the country's leader in rentals of high-quality furniture that lessees have no intention of buying. In the trade, people call CORT's activity "rent-to-rent" to distinguish it from "lease-to-purchase" businesses that are, in essence, installment sellers of furniture.

However, just as Enterprise, as a rent-to-rent auto lessor in short-term arrangements, must be skilled in selling used cars, CORT must be and is skilled in selling used furniture.

CORT's revenues totaled $380 million for calendar 2009, versus $410 million for calendar 2008. Of these amounts, furniture rental revenues were $312 million and $340 million, furniture sales revenues were $61 million and $62 million, and rental relocation revenues were $7 million and $8 million. CORT operated at an after-tax loss of $1.4 million for 2009 versus after-tax profits of $15.7 million for 2008 and $20.3 million for 2007. Headwinds from the "Great Recession" that began in 2008 have caused the shift from moderate profit to the small loss that occurred last year.

CORT has made several "tuck-in" acquisitions since its purchase by Wesco; most recently, the residential furniture rental division of Aaron Rents, Inc., purchased late in 2008. Earlier in 2008, CORT expanded its operations internationally, through the purchase of Roomservice Group, a small regional provider of rental furniture and relocation services in the United Kingdom, now doing business as CORT Business Services UK Ltd. Factoring out the effects of those acquisitions, CORT's core revenues fell by almost 20% in 2009, reflecting the hammering caused by the severe economic recession. So far, CORT's business has been melting away faster than CORT can fix it.

Shortly after its acquisition by Wesco, CORT started up a nation-wide apartment locator service, originally intended mainly to supplement CORT's furniture rental business by providing apartment locator and ancillary services to relocating individuals. Paul Arnold, long CORT's able CEO, and his management team, have devoted much effort in recent years, expanding CORT's rental relocation services, and redirecting them toward the needs of businesses and government agencies who require a skilled and able partner to provide comprehensive and seamless relocation services for the temporary relocation of employees worldwide. These efforts had not yet gained traction when recession hit. CORT is now focusing its efforts more on cost containment than on expansion of services.

Under Wesco's ownership, CORT has continuously undertaken to improve its competitive position. With several websites, principally, www.cort.com and www.apartmentsearch.com, professionals in more than 80 domestic metropolitan markets, affiliates servicing more than 50 countries, almost twenty-one thousand apartment communities referring their tenants to CORT, many ancillary services, and its entrée to the business community as a Berkshire Hathaway company, CORT is better positioned than previously to benefit from an economic turnaround if it occurs in due course. Near term, we expect more of the difficult business conditions of the recent past, but we do not expect another operating loss at CORT in 2010. Instead, we expect disappointing profits.

More details with respect to CORT are contained throughout this annual report, to which your careful attention is directed.

Precision Steel Warehouse, Inc. ("Precision Steel")

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, were pounded by the "Great Recession," exacerbating a long-term reduction in demand resulting from movement of manufacturing outside the United States. Revenues were $38.4 million for 2009 versus $60.9 million for 2008. Sales volume for 2009, in terms of pounds sold, declined by one-third and represented less than half the annual volume that Precision Steel had sold thirty years earlier, when it was acquired by Wesco.

Precision Steel operated at an after-tax loss of $0.6 million in 2009 versus an after-tax profit of $0.8 million in 2008. These figures reflect after-tax LIFO inventory accounting adjustments increasing after-tax income by $1.5 million for 2009 and decreasing after-tax income by $0.7 million for 2008. Had it not been for the LIFO accounting adjustments, Precision Steel would have reported an after-tax operating loss of $2.1 million for 2009 versus after-tax operating income of $1.5 million for 2008. Moreover, the $2.1 million pre-LIFO-effect loss last year would have been about $0.5 million greater without after-tax profits from a couple of Precision Steel's small businesses that are different from conventional steel warehousing.

We do not consider Precision Steel's recent operating results to be a satisfactory investment outcome, particularly when one compares its recent performance with its after-tax operating earnings which averaged $2.3 million for the years 1998 through 2000. And, because of the ongoing recession, more difficulty for Precision Steel will surely lie ahead.

Apart from the recessionary-caused weakness, the general and ongoing decline in Precision Steel's physical volume is a serious reverse, not likely to disappear in some "bounce back" effect once the economy recovers.

Terry Piper, who became Precision Steel's President and Chief Executive Officer in 1999, has done an outstanding job in leading Precision Steel through very difficult years. But he has no magic wand with which to compensate for competitive losses among his best customers or from the weak economic conditions. He is redoubling his efforts to pare costs, which must be his response to conditions faced.

Tag Ends from Savings and Loan Days

All that now remains outside Wes-FIC but within Wesco as a consequence of Wesco's former involvement with Mutual Savings, Wesco's long-held savings and loan subsidiary, is a small real estate subsidiary, MS Property Company, that holds tag ends of appreciated real estate assets consisting mainly of the nine-story commercial office building in downtown Pasadena, where Wesco is headquartered. Adjacent to that building is a multi-story luxury condominium building which MS Property Company has recently built and is in process of marketing. For more information, if you want a very-high-end condominium, simply phone Chris Greco (626-585-6700). MS Property Company's results of operations, immaterial versus Wesco's present size, are included in the breakdown of earnings on page 1 within "other operating earnings."

Other Operating Earnings (Loss)

Other operating earnings (loss), net of interest paid and general corporate expenses, amounted to ($6.9 million) in 2009 and ($0.4 million) in 2008. The 2009 figure includes a $6.2 million after-tax writedown of the book carrying value of a condominium building that was completed in the worst condominium market in decades. Other components of the other operating loss in 2009 were (1) rents ($4.1 million gross) principally from Wesco's Pasadena office property (leased almost entirely to outsiders, including Citibank as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiaries, less (3) general corporate expenses plus expenses involving tag-end real estate and real estate held for sale.

Consolidated Balance Sheet and Related Discussion

Wesco has unusual balance sheet strength, concentrated in security holdings of its insurance subsidiaries. These holdings, in turn, are concentrated in a few securities. Details can be found in Note 2 to the accompanying financial statements.

Wesco carries its investments at fair value. As a result, unrealized appreciation or depreciation, after income tax effect, is included as a component of shareholders' equity and net worth per share.

Affected substantially by changes in market value of securities owned, Wesco's yearend net worth per share has varied only slightly during recent tumultuous years. Figures are as follows:

2006	$337
2007	356
2008	334
2009	358

These results are not impressive. Moreover, if net worth per share had been computed at its low point in the recent stock market panic, stability implied by the foregoing figures would have been considerably lessened.

We repeat our standard warning. Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway. Moreover, the quality disparity in book value's intrinsic merits has, in recent years, continued to widen in favor of Berkshire Hathaway.

The Board of Directors recently increased Wesco's regular dividend from 39½ cents per share to 41 cents per share, payable March 4, 2010, to shareholders of record as of the close of business on February 4, 2010. Shareholders can thank Director Elizabeth Peters for the recommendation that Wesco *increase* its next and future dividends to ensure that shareholders are paid in even pennies.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries, as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Shareholders can access much Wesco information, including printed annual reports, earnings releases, SEC filings, and the websites of Wesco's subsidiaries and parent, Berkshire Hathaway, from Wesco's website: www.wescofinancial.com.

Charles T. Munger
Chairman of the Board
and President

Dated: February 26, 2010

Wesco 2010 Meeting Notes, Part I

The meeting was called to order at 1:57, the nominees for director were elected, and the meeting was adjourned at 2:02.

Charlie then announced that he would follow the same format as last year, in which he'd "prattle" for a while before taking questions from the floor, except that this time he wouldn't ask himself questions. "I'm of course flabbergasted that we have so many people coming to Pasadena after Omaha"; obviously we "have some addicts out there." He will aim to cover matters not covered in Omaha.

Wesco's market cap has grown from $20 million to $2 billion under current management, a "failure" compared to Berkshire but pretty good compared to other things, especially to almost every other California savings and loan; virtually every other S&L "went blooey." Why? Because running a big firm living on a small spread is "very precarious if you're ambitious." If you pursue 10 to 12% growth, you'll take your institution into ruin. Your competition will make bad loans, and you'll either have to fire people and cut back or join the race to the bottom. It's like Greek tragedy. The same problem exists on Wall Street. Why is there no better system for preventing ruin due to deteriorating asset quality? Because wealth leads to power which leads to political influence and bad audit standards. "We were on the edge of something deadly serious."

Why can't we get the "peace process" right after the financial blowup the way we got it right with the Marshall Plan after World War II? Because "our elites failed us." Academia is still teaching failed financial ideas. Charlie has thought about why some high-IQ people make bad decisions while other make good ones. "If your way of making a living depends on X, it's hard to convince yourself of non-X" (which he attributes to Upton Sinclair). To be in the "sane minority," you have to practice right decision making just as you practice making the right swing in golf.

Other folly: Diversification ("diworseification")—it can avoid disaster, but it can't find success; beta—low beta won't cause success either.

Charlie pointed out Li Lu in the audience as someone who liked business school but didn't learn much there, except when Buffett gave a lecture. What we do at Berkshire is very difficult and therefore hard to teach. Business schools fail by teaching what is easy to teach but less useful. Going back to teaching business history as Harvard used to would be good; there's a lot to be learned from the rise and fall of GM, or the rise/fall/rise of railroads.

Charlie told the story of a friend who learned in business school to prosper by abusing his suppliers, driving up their working capital while driving down his own—it was simple

algebra. On the exam, he gave the math the prof wanted but said it was asinine; in the real world he'd want his suppliers to prosper and be happy. That's how he behaved in the real world, and to say he prospered himself is a gross understatement.

A second anecdote about a friend: Guilford Glazer. Back from the war, he was admitted to Harvard Business School, but his father's machine shop was struggling, and he asked for a year's deferment to help out, which was granted. A year later, he asked for a second deferment. The Harvard guy asked, "How many employees did you have a year ago?" "Fifty." "And now?" "Nine hundred." "I don't think you need to come to our school. Why not just stay where you are, and come by later and endow the place."

Guilford's father gave him some advice relevant to recent events: only sell things that are good for the customer. He took the advice, and is now a billionaire.

Soccer is also relevant: In soccer, it's hard to win if the other team has a really good player. If you let players do what they want, they'll "work mayhem" on the other team's star, so you have referees running up and down the field to limit the mayhem. It's the same with other highly competitive people like investment bankers; you can't expect them to rein themselves in, so it's government's role to referee. "At its peak, something like the Lehman firm just before it went under was pathological," "like the worst boiler-room operators," far from Guilford's father's advice of selling people only things that are good for them. The people who did this mostly blame others for the bad results.

You need a referee; yet Fannie Mae and Freddie Mac had 200 people at OFHEO to supervise them, and "right under the nose" of OFHEO they went bust and used phoney accounting to juice the executives' bonuses. It's not enough to have a regulator refereeing; there's co-option of the regulator, or simple bureaucratic inertia (as with Madoff and the SEC), and there's no point giving more authority to such regulators. So you must curtail the activities that are permitted. Not everybody can be trusted to do what Goldman Sachs does, so it must be curtailed—and Goldman Sachs must share in the curtailment. It was done in the 1930s, and it worked.

We don't need the capital allocation of civilization to be mixed with a casino. We need to separate commodities and derivatives from investment banking. Underwriting, running margin accounts for hedge funds, advising, commissions, spreads—there's a lot of legitimate activity for investment banks to do; they don't need to do everything else. They could spin off the people and capital associated with other activities; there would be no big hardship involved.

Charlie digresses to comment that it's hard to sit up here in his 87$^{\text{th}}$ year. It reminds him of a story about George Burns, late in life, receiving a singing telegram featuring four beautiful girls. "I'm sorry," he said, "but I'm afraid that one of you will have to come back tomorrow."

The referee needs to say, If you're going to be backstopped by government credit, there's a whole bunch of stuff you can't do; otherwise you get Lehman.

On Goldman Sachs: they have the "best morality and wisdom" among the investment banks, and Charlie doesn't like the government jumping on them, although he doesn't think they're doing it to be "asinine" on purpose but just stumbled into it.

Charlie knows a poker game where the best players like complicated games because they make it easier to beat the less skilled. It's the same in finance. Too many Caltech grads are going into finance. But in finance you clobber your own customer by being cleverer. For example, in Korea and Mexico, investment bankers sold ordinary businesses currency derivatives that made a little money usually, but eventually blew up. "When a guy is offering you free money, don't listen to the rest of the sentence" – Munger's Rule. It's a *mistake* to unethically rook your own customers; we won't miss it if it's curtailed.

A lot of this happened because accounting failed. For example, the derivatives book Berkshire acquired was said by the accountants to be worth something positive, but the reality turned out to be negative $400 million. We don't need mark-to-model accounting. There is too much math in accounting and not enough horse sense. For example, over- and under-reporting assets look equally bad mathematically, but *over*-reporting is much more dangerous. Lower-of-cost-or-market valuation sometime caused under-reporting, but letting people mark assets *up* causes real trouble. Charlie gave the example of the Morgan bank switching to allow trades to be marked up, because, they said, their traders would leave if they didn't. The explanation was honest, but the attitude was crazy.

You can look at major banks' balance sheets and see hundreds of billions of dollars of uncleared derivatives. It's like hydrogen and oxygen sitting by the roadside, waiting for a flame.

Is there any example to give us cheer? Yes, Lee Kwan Yew of Singapore. The average guy in his ethnic group married a pretty but less intelligent woman; Lee, however, noticed one who was slightly smarter than he was, and married her. His son is now prime minister. Lee drained the malarial swamps without worrying the effect on some little fish, fined people with stagnant water in their back yards, and got rid of malaria. To solve the drug problem, he looked around and found the solution in the US, of all places. He copied our military: urine tests at any time and mandatory rehab on failure. His policy was to check hard anything that might grow like cancer. If you tried to start a gang, your fifth or sixth recruit would turn out to be in the secret service. It led to prosperity. It was paternalistic, but we need more attention to his model. Singapore doesn't have 100% free speech; it's a crime to insult the ethnic Malay minority. Charlie thinks Lee's Singapore has had a positive influence on China. They saw the Cultural Revolution wasn't working and were impressed by what they saw in Singapore. Charlie wishes we were more like Singapore; "in many respects we're too damn permissive."

Permissive accounting led to Enron booking twenty years' projected future profits as an asset. We have to say no. Another accounting example is setting reserves for banks by actuarial techniques: When there's a boom on, there are no losses on loans, so you let your bad debt reserve go to zero just when it should be building up most—insane. You have

"mathematical consistency," but it makes no sense. Yet another: When all your creditors are scared, with good reason, that you'll go broke, and are willing to sell your debt for forty cents on the dollar, you now get to book a huge profit, even if you have no cash to actually buy the debt in.

Some of our better leaders like Jamie Dimon are complaining about accounting standards—actually, only him. "My hat is off to him," but I'd take away his derivatives book if I could.

By the way, some investment banks actually bought casinos; "why run a casino in drag if you can run a real casino?" But a casino isn't a useful thing, although it's a great business, and running a bank as a casino avoids the fixed assets and restrictions on location that apply to real casinos.

Back to Wesco. What about the future? succession planning? You shouldn't think there is a future for an independent Wesco. You guys bid the stock up to "where it would violate all of Warren Buffett's principles as a capitalist" to buy you out with stock, and we don't like to force people out with cash, but it will happen eventually. Either the price will be right, or at some point it will be just a blip to Berkshire. "I don't know why you like this sort of thing. I was never this popular in my youth."

The Berkshire model is extreme decentralization combined with extreme centralization of excess cash. Both features are extremely peculiar but the benefits exceed the harm from each. Centralization of investment means they think about opportunity cost and look at opportunities broadly. For example, Charlie was once asked to look at company in China, liked it, but said no because he knew of something else he liked even better.

Why high-tech stuff like Iscar and BYD after all these years? When Charlie was young he poured money into a scientific-instrument company with a great oscillograph. Then some venture capitalist hired the top guy away, and the invention of magnetic tape came along and suddenly made the oscillograph obsolete. Damn near went broke and soured on high tech. So why now? Multiple models, and in this case the northern pike model. If you throw a few northern pike into a lake full of trout, soon you have big pike and few trout. Charlie recognized Walmart as a northern pike. Costco is too, plus they have Gil Glazer morality; he wouldn't want to compete with Costco. Bill Gates said more than once that the standard result for a dominant company when disruptive new technology comes along is to fail. So why invest in tech now? Because some models got so powerful that we thought we could make predictions.

If Charlie said he could lift 800 pounds you'd laugh, but if you saw him do it a few times you'd change your mind. The same thing happened with BYD. True, we bought in early at a much better price than currently through the wisdom of Li Lu. How can you know we got it right? You can't, but we're not going to do it often—there aren't that many BYD's. Charlie doesn't consider it venture capital; more like betting on a sure thing. Big lithium batteries for utilities to time-shift, electric cars, better cars for the masses in China—these are all Holy Grails. Why do these folks in China have the lead in pursuing them? A very

unusual individual in a very unusual place.

Charlie recently drove a BYD car with a 200-mile battery around the parking lot at Dodger Stadium and was very impressed; it compared favorably to his Mercedes 550. Why is Mercedes forming a joint venture with BYD? It can only be because they've tested the battery.

Still, Charlie's not recommending any of you get into tech. The old ways were safer. But there's an exception to every rule, and "I think I'm right about BYD." And you're entitled to an explanation.

Questions and answers to follow in Part II.

Wesco 2010 Meeting Notes, Part II

Questions and Answers

[I've tried to identify the questioners with as much as I caught of their self-identifications.]

Q *(New York BRK shareholder)* How big a problem are distorted incentives of regulators vs. the regulated (pay differentials and regulators hoping for later jobs in industry)? In Singapore. . .
A Yes, it's a problem, and yes, I like Lee Kwan Yew's solution of raising regulators' pay (he also has draconian anti-corruption policies). But in the US, I think the problem with regulators is more "cognitive insufficiency" than corruption.

Q *(Whitney Tilson)* Cayne and Schwartz are up testifying to Congress that there's nothing they could have done to prevent the meltdown. Are the hearings a circus?
A There's not much point in the hearings. It's human nature to blame others. But Congress is "mad," and rubbing their noses in the mess they made isn't useless.

Q *(David Winters)* When will insurance pricing be better, and Berkshire able to grow float?
A Odds are float will not grow much, and may even decline. It's very hard to increase it. "Is that negative enough for you?"

Q *(Some media guy)* Questioner was in China and really blown away; he doesn't think the US is recovering and getting back to basics. Why aren't we getting back to basics, manufacturing and infrastructure?
A Of course we're seeing more troubles than we're used to, and we've failed to change some things that need changing, such as education. But I'm not as pessimistic as you are; I'm optimistic about California despite it's troubles—it has its climate, it faces Asia, it has an influx of new talent, especially from Asia. And a big mess brings on corrections; "this very failure that's bothering you so much looks like the first rays of sunshine" to me.

Q Any tips on how to develop temperament and character in young people of the BRK type, rather than the MBA type?
A It's good to understand models for failure. For example, East Germany. The best 5 million left and the worst 17 million stayed. Then they lived under Communism 60 years. That'll ruin even Germans. The same thing is going on in central cities. It's not an easy problem to fix. Prevention is preferable, though it's not easy to preemptively stamp things out in a democracy. You can't blame the Greek politicians for trying to make it easier for Greeks, but when it comes unglued. . . . In business, if you see high-quality people leaving A for B and C, and no high-quality people going into A, that's a similar model for failure. I recommend a tough-minded, rational approach, plus good will. An ounce of prevention

is often worth a ton of cure.

Q *(James Armstrong, Berkshire shareholder, Pittsburgh)* Last year you talked about a smart electrical grid. Are the BNSF rights of way useful for that? Could that add anything to Berkshire's net worth?
A I've never heard anyone talk about it but can't imagine the rights of way full of towers. "Put me down as skeptical."

Q Is BYD too dependent on a single person?
A There's a risk, but I'm used to it, working around our 80-year-old gallant leader. [At this point, Charlie asks Wang Chuanfu and BYD's vice-chair to stand and wave (applause).]

Q *(Alex Laga, a BRK and Wesco shareholder, Milwaukee)* An engineering mentality is prone to paralysis by analysis and to a fascination with models for their own sake. How does one avoid that?
A Look at BYD: 16,000 engineers but *determined* to be rational. They don't like unnecessary delays, nor analysis for the sake of analysis. By contrast, India has too much paralysis by analysis.

Q *(Austin, TX)* WEB credited you with giving him the concept of "durable competitive advantage." What are the best ideas he's given you?
A Warren knew about durable competitive advantage. He didn't need me. The amazing thing is we did so well while being so stupid. "That's why you're all here: you think that there's hope for you." Go where there's dumb competition. Patrick Wolff once told me I was better at what I did than Wolff was at what he did. I said no, I just played weaker competition.

Q *(Australia)* How do you determine bet size when you invest? Do you use the Kelly formula?
A We don't use any formulas. If you're referring to "Fortune's Formula," it's very intelligent if you get to make lots of bets that pay off quickly, but we get very few opportunities and our problem is to get enough of them to invest a lot of money. I suspect I may have intuitively used the formula when younger. It's correct, but of very little use to how BRK operates.

Q Given the high price, and in stock, for BNSF, can you improve their operating margins to CN levels?
A That's an easy one: we don't have to do "one damn thing—just let Matt Rose do whatever he pleases."

Q To what extent did you share ideas with WEB before you began co-investing?
A I always talked over ideas, but not with many people.

Q *(San Diego)* Excesses in the economy blew up in '08. You compared it to being on drugs. Are things worked out, or is there a hangover still?
A Of course it's not worked out. What you and I see as excesses are regarded by the

people doing them the way a diver regards his air hose. "I need it and I want it and so I should get it" is childish. We need to make changes, or we'll get more trouble.

Q *(Germany)* What do you think about central banks printing money and the ECB accepting Greek "garbage" as collateral?
A Everybody knew Greece was problematic when they joined the EU. It's amazing we didn't get a Greece-type problem sooner. It's very hard to fix: you don't want to set a bad example, nor let them go under. Ireland got a big benefit from joining the EU, but Greece threatens the whole system. [Charlie paraphrases a Woody Allen line: "Today we are at a crossroad. One road leads to hopelessness and despair; the other to total extinction. Let us pray we choose wisely."] I'm glad it's not my problem to solve, though I believe that, with my mindset, I would have acted earlier.

Q You suggest studying people one admires and the eminent dead. You've mentioned Lee Kwan Yew, Ben Franklin, Paul Volcker. Who else?
A There are lots within Berkshire. An example: managers are reporting, and one says he uses the 80/20 rule, focusing on the 20% of the business that makes 80% of the profit. The next says he does the opposite, focusing on the 20%-profit businesses that you can buy cheap and improve. They're both correct. You need multiple models.

Q *(College student)* I want to invest in Berkshire but I'm worried about succession and the future.
A BRK will be very successful long after we've gone. It has wonderful businesses and a durable culture.

Q If you were starting out with a small amount of capital, where would you focus?
A I wouldn't go where the big boys have to be, trying to decide whether Merck's pipeline is better than Pfizer's. I'd go where there are market inefficiencies and your work could lead to knowing important things that other people didn't.

Q *(Fund manager, New Delhi)* I admire your "lattice work" model but in applying it find that adding to one's toolkit takes a long time because you have to fit new things into a complicated framework. Is this inevitable or is there a way to speed up integration?
A I was born with a mind that works that way and am also curious, so learning isn't work but play. If your nature's different, you'll "have to figure out your own damn answer."

Q *(Student, Toronto)* Why is it the government, rather than someone like Berkshire, bailing out the banks this time?
A It's way worse this time. Nobody in his right mind wanted to see how far it would have gone if the government hadn't acted. It's a credit to democracy. England showed us that we could intervene directly in major banks, which was much better than TARP. It's a credit to Paulson that he switched plans when he saw a better one.

Q *(South Pasadena)* What about those condos Wesco built next to the headquarters building?
A I'm glad you brought that up because it's like rubbing my nose in financial failure, and

that's good for me. We had surplus property and decided to build condos several steps up from what you could buy in downtown Pasadena. We came to market in the worst condo market in a long time. We're selling condos at prices that give us a modest loss and resisting doing stupid things. Eventually there'll be one condo left and two or three buyers. I think it'll make a lot of money eventually for the buyers, but never for Wesco.

Q You said you regret so many Caltech grads go into finance. But mightn't they end up running those businesses and do better at it than Fuld?
A That could be true. You could probably take anybody at random out of Caltech and have them do better than Fuld. But there's an opportunity cost; there's a loss to civilization when bright people go into money-grubbing instead of science.

Q Can you comment on the state of the insurance business?
A Casualty insurance is intrinsically a very difficult business. As in financial businesses, people delude themselves to maintain volume. I wouldn't be looking for investments in the field. Berkshire is different, and a few others too, but those others are generally known and priced accordingly. Reinsurance is even worse.

Q *(Ottawa)* WEB says he expects a "reasonable return" on BNSF. What percentage or range of percentages is reasonable? Also, any books you've read in the past year and recommend?
A Berkshire is looking at opportunity costs. We spent 6% of shares outstanding to acquire BNSF. We were getting low returns on cash, and we paid low rates on the money borrowed to do the deal. It's a better deal for Burlington shareholders, but that doesn't mean it's a bad deal for Berkshire shareholders. Bringing in Matt Rose, who's quite young, is a huge plus. Though not an iron rule, we hope to make, say, 10% pretax long term when buying with equity. But this was part equity, part debt. Stocks generally will probably do worse that 10% pretax; this isn't an environment you should be happy about. We might be wrong about getting 10%, too. As for books, the ones about the Great Recession are all very interesting. John Paulson is a very interesting story; his imitators are going to create a lot of trouble. The same applies to me to some extent; I try to atone by doing other things.

Q *(Toronto)* It seems the rate of change in business is speeding up. Does that make things harder?
A I don't know what will happen in the next 20 years and have very little reason personally to care. That said, the most interesting rate of change is in China—so fast, so pragmatic that I am quite optimistic. An amazing percentage of Chinese Communists have engineering training. "That's my kind of Communist." We're too critical for expecting them to do things exactly our way. They're coming up the technical competency curve at a rate with no precedent except perhaps Japan, and they're a big country. It's very difficult to compete with them. They're wise to foster people like BYD who are trying to make things better rather than just cheaper. In my youth, I liked the King Fong Restaurant in Omaha. Recently, I drove by, and downtown Omaha has gone to hell but it's still there. The Chinese find a way to survive.

Q *(San Jose)* You said solar was too expensive for your house, yet Midamerican is investing in solar and wind.
A I don't second-guess Midamerican. As for photovoltaic, I thinks it's about to get a lot cheaper, and therefore isn't a buy now. But I could be wrong.

Q Float at Wesco has gone up quickly compared to float at Berkshire. Can it keep going up? Also, why was it Berkshire and not Wesco that invested in BYD?
A The second one is easy: strategic stuff almost always involves BRK, which is bigger and famous. To repeat, Wesco is not a smaller Berkshire. The insurance is a gift; if Wesco wasn't part of BRK we wouldn't have any way of getting it. As for CORT, it "looks pretty damn mediocre" and was bought at the top of a boom; still, I think it will do all right over time. You shouldn't analyze Wesco as an independent entity; it's a "weird historical accident."

Q *(USC MBA student)* Can you come talk to us?
A I used to once a year; one talk's in *Poor Charlie's Almanack,* and it wears pretty well, so you don't need a live Charlie. Warren does a lot of that and likes it; my taste for it is limited, so I can't help you.

Q Does WEB prefers durable competitive advantage to Graham-style investing because it's a better model, or because it works better for large amounts of capital?
A If I were young and had a small amount to invest, I would be looking in the small-cap world.

Q *(Los Angeles)* Is CORT in a cyclical or secular decline? Is there a goodwill writedown coming? And what about Goldman Sachs?
A CORT will do OK and justify the price paid but not be a worldbeater. But it's getting pretty dominant in its niche, so maybe I'm too negative. On Goldman: The total return derivative is a way to avoid margin limits and deceive accountants; I hate its social implications. I dislike other derivatives too. Warren wrote a letter against allowing S&P derivatives, but after they were made legal anyway, he invested in them; nothing inconsistent in that. In a world where derivatives were allowed, I see no reason to think Goldman was misbehaving, just doing what others were. The disadvantage is that it's hard to explain to the public. I suspect they'll change; Blankfein is pragmatic and flexible. Goldman deserves its share of blame for helping to persuade the government to allow derivatives trading, but no more. The idea that any sort of risk transfer between consenting adults ought to be legal is wrong. But Goldman Sachs shouldn't be singled out.

Q *(Boston)* Why did Coke buy back its bottlers, and what makes a good distribution business?
A I don't follow Coke, but originally they spun off low-margin businesses into non-consolidated entities to make the accounting look better. That's not a Munger-type thing to do, so if they're undoing it, that's a good thing. By the way, I think the new CEO of Coke is the best we've had in a long time.

Q *(Chicago)* Clayton's products are great, but it's almost impossible to put a Clayton home in Chicago due to zoning. Will that change?
A Kevin Clayton is very interested in taking Clayton techniques upscale and getting past regulatory problems. Clayton houses are improving. Charlie thinks we'll see more Clayton-type methods used in the future, though it's a slow process of change; the custom home approach is *so* expensive.

Q *(Los Angeles)* Can you recommend investment books for children and strategies for getting them interested in investing?
A I'm not sure I believe in getting you children interested in investing. For myself, I think that investing helped with wisdom acquisition, and wisdom acquisition is a moral duty; but the money all goes away when you die.

Q *(Shreveport)* Why do you and WEB read 5 newspapers daily? And will Goldman Sachs divest its derivatives business?
A To the second question, not unlessed forced to, any more than a diver will step on his own air hose. To the first, "It's all I can conveniently crowd in." "I am particularly charmed by the *Financial Times*," but I also like the *Wall Street Journal;* I'd read more if I had the time. I skim. I don't know anyone who's really wise in the practical world who reads no newspapers. Maybe you can do as well with keyboards and multitasking, but I don't think so.

Q If you were 35, would you move to Singapore?
A I'm such a lover of the US I'm not going to move to Singapore. With all its defects counterbalanced by its virtues, I love this country. The move might be right for somebody else. If crime goes up by a factor of three, affluent people might move to Singapore, but I won't.

Q *(Santa Monica)* You said reinsurance is a tough business, so why the Swiss Re and Munich Re investments?
A Warren makes those decisions. Those are both respectable businesses that have been around a long time. They're portfolio investments at what seemed like reasonable prices. That doesn't change my general view of reinsurance. *Of course* it's difficult to judge whether to invest in them. I like no-brainers like Costco and BYD better, but you don't find very many.

Q *(Los Angeles)* With banks moving away from mark-to-market and keeping troubled assets on their books, how is Wells Fargo affected?
A Wells Fargo got very cheap at the low tick. Yes, they made mistakes, and yes, they have a lot of work cleaning up Wachovia, but it's a good investment even at the current price. Even the best banks drift with the times and do stupid things, but I suspect Wells faced up to it better. We may be getting changes in credit cards. We've been issuing them to "fiscaholics." I don't like issuing credit at 30% to people who can't really handle it. "But that's a crotchet, not a complaint." However, how many here agree? (Many hands go up.)

Q *(Chinese online journalist)* What fields for investment are you interested in, besides BYD, in China? And what advice do you have for Chinese investors?
A It's hard to imagine finding another one as good as BYD. We'll look, but will be surprised to find another one.

Q Any more add-on activities at GEICO?
A The credit card was "a really stupid decision that got a bad result." I hope we don't find another "opportunity" like that.

Q *(Los Angeles area accounting prof)* Advice to accounting students? And should our investment group buy more Berkshire?
A Huge changes are needed in accounting standards, but that's a problem at the top of the profession. As a professor, you have to hold your nose and teach the standards as they are. We never—well, almost never—tell people when or whether to buy Berkshire. Accounting is a noble profession; double-entry bookkeeping had a big role in the rise of Venice. But accountants fear liability if they make difficult decisions. I would favor exempting them from liability for anything except deliberate fraud, in exchange for requiring them to be conservative.

Conversation with Charlie Munger
July 1st, 2011
Pasadena Convention Center

Opening Remarks:

The question after Wesco was bought by Berkshire Hathaway (BRK) was who was going to pay for the event today. Charlie decided to pay for it to continue the tradition.

Wesco Merger:

Said he feels like a captain who finally got to the port he had always dreamed of. He believes BRK is the right port for Wesco. About one half of the Wesco shareholders became shareholders of BRK. The contract was disadvantageous for BRK because of the losses recognized in Swiss Re. BRK's stock subsequently went to a price that was so low that Wesco shareholders got more shares than Warren and he had ever intended. He thinks there was a favorable wind at the end though.

Warren and Charlie developed a reputation for doing the right thing. It has worked well to be known for doing the right thing, even when BRK has the power and their partners or counterparties do not.

Quote: How nice it is to have a tyrant's strength and how wrong it is to use it like a tyrant.

Academic Discussion

Charlie didn't think the audience would bear listening to this at the end of the conversation so he put it in the beginning. When you have a complex system, what he calls lollapaloozas can be very impactful. These almost always come from a confluence of factors operating in the same direction, but coming from different academic disciplines—economics, finance, and psychology. He has never cared what disciplines they come from though. It is that they come together to have a large impact that is important.

With lollapaloozas in mind, he wanted to let us know how he approaches things. There is a problem that has bedeviled the economic departments of universities. When economists went to the movie theater, they noticed that Coke and popcorn were priced way too high relative to the prices of these goods elsewhere. There have been millions of man hours devoted to understanding this phenomenon. They understand why first class airplane seats sell for more than coach seats but can't understand—using marginal utility—why candy bars sell for so much at theaters.

Similarly, it is well know that car manufacturers sell a car for $40,000 and then sell you an extra gizmo that costs $20 for $400. When you are paying $40,000 for a car, a $400 charge is so small that people barely even notice it and the seller can extract more money out of customers this way. Nothing can be simpler than what he told us but he can't believe how many academics don't understand this. He then suggested that if you can adopt his tricks and his approach, you can do better than most other people.

He then applied the same approach to something that is far more complex. It became orthodoxy from a Keynesian point of view that you can borrow and print money to ameliorate recessions. The Keynesians believed that recessions would be short and depressions less likely as a result of borrowing and printing money. People became so enamored with this idea that they thought these economics laws were like those of physics.

The Japanese got in trouble because of an idiot boom in real estate. They now have tried everything in the Keynesian book to try to fix that. They have had to deal with 20 years of stasis, which they are uniquely able to handle. They are a nice and polite people. However, Americans and people from most other countries would likely not be able to go through 20 years of stasis. If the "new" laws of economics do not work as well as the professors think they will, Americans will be in trouble.

Of course Keynesian and monetary tricks do not work as well when everyone knows you are playing them. For example, things that worked in the 1930s might not work now. Back then the US had better credit and people did not use the polls to make themselves rich. Meaning, people did not get voted into power and then use their power just to become rich. This is a lollapalooza system.

Next, Charlie provided an explanation of Japan's economic malaise that is not commonly cited. Japan is an export dependent economy. In the late 1980s and 1990s, Japan got huge and credible new competition from China and Korea. They got this because the traditional laws of economics were working well in China and Korea when they adopted something like free market capitalism. The main competitors got more competitive and this impacted Japan substantially. This is an explanation that you never hear. This is why you need to try multiple approaches to solving problems—using checklists.

Additionally, Charlie recently re-read Matt Ridley's *The Rational Optimist* again. This is a great book. Ridley is absolutely charmed with the way that free market capitalism changed the world. Specifically, he has fallen in love with the idea that the division of labor was the main contributor to this success. He only looks at this explanation though and it is wholly inadequate. There are multiple factors that have made free market capitalism so successful. Even if Stalin were running a pin factory (made famous by Adam Smith in *Wealth of Nations*) he would get efficiencies out of it. The process of competition between different operations and companies causes the power to be allocated to people who are good and can perform a great service. But, if you just stop there you miss other things. For instance, what happens is that the owner of a business gets "reinforcement" very often. Each time the cash register rings he or she gets an "aha" feeling. There are lots of rewards and punishment in free market capitalism that do not necessarily apply to someone who works for the Department of Agriculture (and can't be fired) or who is a communist in Eastern Europe.

The takeaway is that there are all kinds of problems that are better solved by going through a checklist. This works well in primary medicine too. Only a terrible internist jumps to the first conclusion and sticks to it. (Sadly, this represents about 75% of internists.)

Blue Chip Stamps

He then went on to talk about Blue Chip Stamps, a "doomed" trading stamp company. Almost all of these companies are now dead or almost dead in general. However, when this business was more profitable it produced a large float like a casualty insurance company. What was interesting about the task of investing that float was that BRK only found 3 big things to do in decades with the money: it bought Sees, Buffalo News and control of Wesco. The idea that he and Warren only made 3 moves is interesting given how investment bankers are always pushing people to buy things. It is "boring" to run a business and make sure each restaurant is clean, for example. It is much more fun to look for things to buy. However, almost any data suggests that most shareholders lose with all of these mergers—academic studies prove this. But, BRK shareholders did not lose because he and Warren only did 3 things and were patient. They were able to be patient because they had something else to do with the money. They had the option to buy marketable securities. Most companies don't have this option and the combination of options gave them a respectable repertoire provided that they were patient.

Strangely, the worst thing that could have happened was the purchase of Wesco. The other two businesses they bought were way more profitable. But, even so the Wesco stock went from $5 to $385. Even if starting Microsoft was better financially than buying Wesco, he and Warren don't care. They don't want to fall prey to envy. Envy is stupid because you can't have fun with envy—envy always represents a total net loss. There is always someone doing better than you.

Another advantage to BRK's process was that Warren and Charlie were learning as they went. They didn't understand the power of a great brand until they bought See's Candy. They found that they could raise the price 10-15% each year and nobody cared. This understanding then changed BRK and its investment pattern. We are all ignorant—no one knows enough now to cope with the future. His motto is to pay yourself first—protect your own mind and make it better. You always have to learn. Increasing rationality is a moral duty and it is very important to keep improving as much as you can. That's how he and Warren went at it and it worked well.

They weren't the smartest guys—they were massively ignorant. In fact, many of the major successes of BRK started off with massive failures. For example, they bought one of the 4 major department stores in Baltimore. This was really stupid! But they recognized the mistake, tried to exit, and did. They were able to sell it for what they bought it for, basically. Out of the contacts they made when they bought the department store they were able to buy a niche retailer that made them a lot of money.

Many people graduate from Wharton now and think they know how to do everything—that is a big mistake. What is needed is a lifelong learning process—this is both helpful and a lot of fun. He said that he has had so much fun learning. In fact, it is amusing to see economics professors spending all these man hours on silly problems that he could solve with his left hand even though he never took a class in economics.

The Great Recession

The bubble in America was from a combination of megalomania, insanity and evil on the part of a lot of people in banking—both mortgage and investment banking. Greenspan was a smart man but he overdosed on Ayn Rand at a young age. You can't have total freedom to create gambling games. Much of what crept into investment banking was a gambling game in drag—it was not capital raising. Now, the banks have developed an advantage in derivatives and do not want to give it up. A casino would never give up slots to keep roulette and blackjack. Similarly, the banks don't want to give up their best businesses to save the rest of us from risk. It makes sense that banks don't want to give it up.

Betting on a stock index is like betting on a bucket shop. The banks brought back bucket shops with the derivatives markets. With casinos you have to have parking, bars, restaurants and entertainers. But the banks have a casino with no overhead. The government then allows them to operate with leverage through the repo system. Conservative investment banks went to 30-50x leverage, making small returns on each transaction but making a lot of money in aggregate.

Then, the accounting profession allowed banks to show income and assets that weren't really income and assets. Accountants didn't think they had a responsibility to show the actual mess that could bring down the entire system. The medical system wants to prevent epidemics but the accounting profession does not want to deal with difficult and systemically risky issues—they want to charge more by making everything more complex. This is a contemptible approach. What accounting figures have expressed contrition? What major person in the US has been embarrassed by US accounting? Very few. But one such person is Jamie Dimon of JP Morgan who has written scathing criticisms of the accounting rules in his annual reports.

As an example, bad debt reserves go to zero in a boom. What kind of maniac would think that is good accounting? Only a CPA or a professor of accounting. The rest of us are grown-ups and know that is not good accounting. Paraphrase of a quote from Burke: For all of the folly in the world to prosper and become rampant, all the good and wise men have to do nothing.

Bernie Madoff has shown no contrition. In his mind, he was OK. Most people think the 150 years he got were unfair. Charlie would bet that Dick Fuld does not feel any contrition today either. He totally ruined Lehman Brothers with his megalomania. This is very serious situation because people won't show any shame. You need to have a society with the right rules to stop people from going crazy. There ought to be rules that only allow banks to do simple things with the government's credit. Remember what happened in the S&L business? Bankers are clearly not that wise or disciplined. They go crazy with envy. If the guy down the street is making a lot of money, it is hard not to try to do the same. Major accounting firms starting selling fraudulent tax shelters. But, when they finally got the whistle blown on them, they reluctantly threw out the partners who were involved. However, he never hears anyone saying they feel ashamed. Well Charlie feels ashamed to be in the same race as these people. Wise laws that protect against people doing crazy or evil things are important.

In the cases of Korea and Mexico, investment bankers sold them derivatives and caused those countries and decade old firms to go bankrupt. It is OK if financial companies are a little boring. Some of our best

banks gave free checking to get people who couldn't handle credit to sign up, a situation that led to overdrafts and people getting socked with huge fees. The banks also programed the computers to process the biggest check first and that led to even higher fees. The banks are paying for these actions through class auctions suits right now—and they should. Wise laws that constrain the worst activities that people somehow are able to rationalize are very valuable.

You are talking to a Republican who admires Elizabeth Warren. He then said that these comments are not quite as contemptuous as what he wrote in the piece about the people who were at fault for the Great Recession.

Current Investment Scene

The scene is very difficult. Charlie likes the "new normal" concept from Bill Gross of PIMCO and thinks the world is going to be lousy. He said we can't love bonds because yields are so low. Further, with so much trouble, the old tricks no longer working in Japan and Europe, and those countries having an "adult" experience, the world looks lousy. Of course picking some stocks carefully will be profitable. However, these returns will be tempered by the fact that there are consultants, managers, traders, and analysts that cost so much and will take profits from the rest of us. Now people are doing what is basically legalized front running because of their skills in math and with computers. Our university endowment and pension funds are paying for this unfair advantage through lower returns. Even worse, the people with power in public pension plans are working in ways to escalate the size of the pensions. Soon-to-be retirees are manipulating pensions by working a lot of overtime during their last year to make the final year salary abnormally high. From there a police officer who has made $50,000 his entire career can retire with a $100,000 pension. This is evil and wrong.

Charlie said that one of his favorite incidents from history occurred in the days of the Punic Wars. Rome couldn't afford to lose wars because when that happened, people became slaves. But, in this unusual case, Rome paid back 2/3rds of the war debt (in hard money) before the war was over. The emperors kept debasing the currency during the period but the right lesson for us to take away was from the guys who had the discipline to pay back the debt. He doesn't like the message that we can't have tax increases in the US under any circumstance (the current stance of Republicans). But, the other idea that the rich should pay all the tax is equally crazy (the current stance of the Democrats). The rich should pay the majority of the taxes but everyone should pay moderate taxes.

In any case, extreme divisiveness is not good. He remembers real nobility among the American political class in the past. After World War 1 the Allies decided to make the Germans really pay for their transgressions and that decision led to the rise of Hitler. If he had been a little wiser, Hitler's ancestors might still be in charge of the world. Charlie claimed that the Allies won the war because of luck and Hitler's blunders. Fortunately, we learned after World War 1 that we don't want to do things that cause desperation and thus decided not to be vindictive after World War 2. The Germans had put Jews in ovens and the Japanese marched people to death. But, what did we decide to do? We decided to give them money and let bygones be bygones. It was a great decision, especially the Marshall Plan.

Keynes wrote *The Economic Consequences of Peace* (in 1919—in which he argued for a more generous peace) and people later realized he was right. Consequently, Americans behaved really well at the end of World War 2. It is hard to imagine the same will be true now. The politicians hate one another and he hates to watch it. He is mildly hopeful it could change. But, the current system is dysfunctional and we need change.

The combination of patience and opportunism is important. Charlie had a great grandfather who had a great influence on his life. This man was one of Charlie's only ancestors who became rich. He told Charlie that you have to be ready to take advantage of opportunities to succeed. This is what they do at BRK. They are always ready. You do not want to be timid when great opportunities arise. It is kind of like how most marriages don't work and you may have only one chance to marry the right person.

Question and Answer Session:

Q1: At this point in your life, what are the 3 most important components of your legacy?

Munger: Charlie hesitated to answer this question because he believes that he is not a good example. Most people who follow his example would turn out to be quite unloved. He is really into self-improvement but certain peculiarities of his personality should not be imitated. For example, copying his insistence on improving his own mind and his irreverence will get you in trouble. Rationality and objectivity work. But, the qualities that bring so many people to hear him speak may not work for others.

Q2: The first question had to do with the Wall Street Journal's deterioration since Rupert Murdoch took over. The second question had to do with whether or not California should become a single chamber state.

Munger: Regarding, the first part, he loves the Wall Street Journal (WSJ), although he has never liked the editorial page. However, the publication he likes best is The Economist. He believes it is the adult intellectual publication of the world. The WSJ is not as good but is good in its field.

Regarding the second question, California should not have a unicameral legislature. He is agnostic on the subject, trending towards suspicious.

Q3: What are your thoughts on Exchange Traded Funds (ETFs) and mutual funds?

Munger: Said he didn't know because he never looks at them. In general, he likes low cost mutual funds and thinks people do better with them than by hiring fancy managers. He doesn't know which funds are better than others because he is not investing in them. He prefers to try to do considerably better by investing in specific companies.

Q4: Question had to do with why Munger has chosen to fight a commercial real estate battle in Brentwood.

Munger: Partly because he is crazy. To the extent that he is not crazy, he has done some things in his life that he knew would be very hard. He has occasionally taken on stuff that would make his life difficult.

He felt a duty to do the right thing, regardless of whether or not it would work out for the Mungers. There is a limit to this masochistic ethos however. His life has been so favored and he is so un-humbled by disposition that maybe he needs some masochism.

Q5: Question had to do with whether or not BRK's stock is undervalued now.

Munger: It is tough to buy stocks and operating businesses. He and Warren are better investors in stocks because they own the businesses and they are better business operators because they own stocks. When they buy companies they pay quite liberal prices—like they did for Dexter Shoes. But, in the case of Dexter, they utterly failed at an easy problem. When they do buy businesses they do not buy them cheaply—however some like See's Candy worked out really well. When all of the deals are averaged out he likes what has happened because BRK owns a ton of good businesses. The future can't be like the past because the weight of BRK's net worth and assets will limit returns. Having said that, he believes that someone who owns BRK stock and does nothing but hold it will do really well.

He likes to think that the culture of BRK has made a contribution to the world. Although, he has waited for a cascade of high ranking executive followers to take only a $100,000 salary (like he does) but it hasn't come. Only the Rockefellers and Carnegies were willing to do that. Additionally, few corporations are as critical as BRK is of other business. As a result, deep down some people really don't like him. For instance, he doesn't make great friends on Wall Street when he says people there are stupid and evil. This is not the way to get ahead in corporate America.

Q6: What recommendations do you have for successfully raising a family and dealing with adversity?

Munger: When it comes to adversity, you have just to soldier through. Being too frightened leads to contempt. Coping with adversity brings opportunities. Don't panic or go crazy. People will always remember the person who could keep his or her cool. When Bobby Kennedy was dying and the entire Kennedy family was falling apart, Jackie Kennedy was the only person who kept her head. Who do we remember? We remember Jackie Kennedy.

Q7: Given the fall in the share price, does BYD's stock represent is a major opportunity right now? What percentage of his money would he put in BYD shares?

Munger: He doesn't want to tout one security—especially when he has avoided early stage companies for most of his life. BYD is a high technology company trying to make lithium batteries that do not blow up. They have 20,000 engineers to cope with these very difficult issues. He will hold his BYD stock to the bitter end because he loves the people. But, he can't say what other people should do with their money. He has very little experience in early stage venture capital (implying that the purchase of BYD shares was similar to a venture capital investment); he is investing in the company because he wants to improve his mind.

Q8: Regarding inflation, what are his thoughts given all of the money printing? Is more inflation ahead? If the US was a corporation and each dollar represented a share of stock, would he buy, sell or hold? (The questioner mentioned that the dollar has lost 95% of its value since the early 1900s)

Munger: He said it is pretty likely that we will have inflation over a 50-100 year period. But, contrary to people's fears, inflation has not halted the success of our civilization. We have had growth of 2% in GDP per person for decades despite the inflation we have had. The questioner suggested that the inflation in the pipeline would represent failure. However, failure is way worse than that. In fact, the situation the questioner described is hog heaven even though the dollar has lost 95% of its value. Charlie said he went to a hotel in Italy and paid his bill in billions. So, what the questioner described with horror is the top of success in Charlie's mind.

If every person in this room had to live with a real investment return of 0%, after tax, he thinks we all should be reasonably happy. A lot of people would not be happy though—look at Greece for example. In Greece, they don't want jobs: they want to sit on their asses as the money comes in. A job is a burden; it wastes 8 hours a day. If he were running the European Union (EU) he would not have let Greece in. He said that we should have an EU, but not for basket cases. When you get into a mess like Europe is in, you have to draw a line somewhere. In his mind, they can't let the depositors of their major banks get wiped out. They can let the shareholders of the banks fail but not the depositors. He knew that the Euro wouldn't work and at some point the EU will have to face the music.

We drew the line pretty well in this country with Lehman Brothers. But, after Lehman failed, we had to intervene to a major degree. He feels good about the way that Hank Paulson, both parties and George Bush handled the Great Recession. The massive intervention was successful. If you assume things will be really tough but you can bear it, you just smile and go on. And if the world is so tough that the Munger's fortune loses purchasing power, so what? Such great wealth may not be good for the family anyway.

Q9: In the US engineering cultures are important. Are there historical precedents of what happens to companies that the market currently thinks are deteriorating (the questioner mentioned Google, Intel and Apple)?

Munger: This is something that he does not know enough about. He does not know how you displace Google but a lot of the other companies will have competitive troubles.

Q10: Munger has been very critical of the financial activities of others. However, in his financial activities, has he added value to society?

Munger: If all he ever did was figure out what securities would go up in price and sat on his ass, then that is not much of a contribution. The only difference is that he is ashamed of it so he has added all of these other activities—like his masochism with property development in Brentwood. He then said that we may think we were at this event due to some nobility in his nature. However, in fact, hosting an event like this is nothing more than atonement.

Q11: He seems like he was very strict as a father. What is his relationship with his children now that they are older? Has he helped his children financially?

Munger: Of course he has helped them financially. Rich people who don't help their children out at all end up having children who hate them. He was lucky in a sense that he was not always rich. He probably

raised his earliest children better than the later ones. Will rich children ever be as motivated as people who had to struggle? No. You won't get people to be willing to suffer and provide "wonderful" hardships for their family. Thus, the answer is that rich people should lose graciously. But, this does not include providing artificial hardships for children—it is just not practical.

Q12: Which economic entities in history were most similar to BRK? What are BYDs competitive advantages?

Munger: If you go back to 1911 and look at the top ten companies of the time, many of them are gone. The 2 main ones that remain are General Electric and Standard Oil. Of all of the big companies of today, Standard Oil stands all by itself. It succeeded because of its engineering culture and from being in the right place. Everything was working for the company. When oil was seeping out of the ground, you didn't have to be that smart. You just had to be early rich and have the ability to buy oil-rich properties. The nature of the game was that as energy supplies got shorter and shorter, oil prices went higher and higher. In fact, Paul Getty became very rich precisely because he had oil reserves that he couldn't pull out of the ground quickly enough and then, while the oil was still underground, the price appreciated enormously.

What is the Standard Oil of today? He doesn't know. There were 13 Standard Oil companies when it got broken up and they were all huge successes. He has no idea what the next Standard Oil is.

Regarding BYD, he likes the fact that they are tackling tough engineering problems. He likes that they put their heads down when they fail and keep trying. He has gotten so old that he would rather make money thinking about people he admires than dealing with other people he doesn't care as much for. Luckily, he admires BRK so he doesn't have to worry about his money.

Q13: Chuck Gillman of Boston Avenue Family Office- Would you like to see more value investors run proxy battles at under-performing companies?

Munger: Charlie said he is conflicted about this subject. He doesn't really like people who run around like vultures raising hell. However, he also doesn't like entrenched managers who are not good and who are over-indulgent. In the end, he does not want more corporate raiding though. He would rather endure the evils we already have.

Q14: How should we prioritize our time based on which stage of life we are in?

Munger: Charlie said that he did not have much advice apart from his general advice to invest in personal learning—he believes in continuous improvement. He doesn't believe that you can change your life midway. You can't be a total jerk and then be nice later in life. If you know where you want ago, you might as well get there sooner. Lifelong learning works and it is a lot fun. He is 88 years old and he is learning more about astrophysics. What could come from it? Very little—but he is really enjoying it. The good news is that he understands astrophysics better than an average 88 year old.

Q15: Will he do this event again next year? How does BRK take care of its cash? Is the company at risk to bank or counterparty failure?

Munger: Said he is glad to host the event this time but he doesn't want to continue because he thinks we need a new cult hero. So, by not hosting the event next year, he is actually trying to help us by allowing us to move on.

BRK is dependent on the modern financial/deposit systems and computer trading systems. Unfortunately, BRK has to deal with people who Warren and Charlie don't like or are whose actions elicit skepticism. For example, he doesn't like credit card companies that are pushing credit on people who will inevitably hurt themselves with credit. At one of the Wesco meetings he said that firms should only make money by selling things that are good for customers—not things that are more like gambling. Yes, he is directing these comments at our leading investment banks.

Q16: If you were a college age students and had 20 years to become an expert in a specific field, what would focus on?

Munger: He said that this is an easy question. When you are looking around for something to do as a young person, you have to select something you like doing. He has never been good at things he wasn't interested in— he is way more effective when he is interested. If god has given you a passion for drawing buildings then you have to be an architect—which is a terrible way to make money by the way. However, he has an architect friend who says he doesn't care if it is a bad way to make money. The man doesn't care because in his mind it isn't work.

A man is a prisoner of his talents. This statement is true in his life as well. He couldn't have been a ballet dancer or a professional football quarterback. Law may not have been perfect for his talents and interests but it was the next best. Unlike others, he was not willing to be ill-paid.

Q17: He once said he sold the best hour of his day to himself. What does that mean? Is Coca Cola (KO) as good today as it was 20 years ago?

Munger: When he was a lawyer, he said he spent an hour to himself in the morning and then gave the rest of the day to his clients. Most people would not admit it if they did that but he thinks it was very valuable.

KO is not as good as it was 20 years ago. Compared to the big companies that sell consumer products however, it is better. But, it is like BRK in that the company is so big that it is hard to move the needle. Think about it this way: if we have to drink 8 glasses of water a day and company can slightly improve the taste of that water, it is a cheap and easy way to get people to drink those 8 glasses of water. It is hard for competitors to knock off a cheap product with a great brand name. That may not be true with a $500 computer though. If he were investing for pension funds, there wouldn't be an account that didn't have KO in it. It doesn't mean KO will do wonders for people, but compared to other companies, he would rather own KO.

Q18: How does he plan his day?

Munger: Said he fills his duties first because he doesn't want to disappoint people. But he says no to many new opportunities—he is brutal in that way. He has an amazingly open calendar—like that of

Buffett. He likes to have the freedom to take calls from friends and family. He doesn't want to be booked like a busy dentist and this flexibility has worked for him. There is an advantage if you have a temperament that allows you to cope with problems that others can't understand. He prefers hard problems and doesn't want to be a dentist (who follows simple processes over and over).

Q19: Regarding Buffett's comments on future performance, is it unrealistic that BRK will outperform indexes slightly over a few years?

Munger: No, it is not unrealistic. If they just held big common stocks it might not work. But, with a mixture of operating business and business owners selling to them because they don't want to sell to someone else, Buffett may get his wish. However, Buffett might not get his wish to be there for 20 years to see it happen.

Q20: What is his advice regarding raising a son?

Munger: Don't preach one thing and then live another life!

Q21: Has being a cult hero limited or improved his ability to do what he wants?

Munger: It has done both. It is only peculiar people like us that he wants to impress. He is lucky because we are the only people he has ever impressed. To the extent he is known by this crowd, he thinks it is a net plus. But, he doesn't want a bigger house or more acclaim. In fact, he has outshot himself already on those fronts.

Q22: Could we get a list of the 99 mental models he uses?

Munger: The women who asked the question appraises him higher than he does himself. He can't do that!

Q23: Question had to do with the prospect of a BRK dividend.

Munger: He said that some of us will live to see a BRK dividend but he doesn't want to see it. It will mean that the company does not have great investment opportunities available any longer. He doesn't want to see what he would consider failure.

Q24: When assessing durable competitive advantages, what does he consider the most?

Munger: He and Warren only look at industries and companies that they have a core competency in. Every person has to do the same thing. You have a limited amount of time and talent and you have to allocate it smartly.

Q25: Do you see parallels between the decline of the US and that of the Roman Empire?

Munger: Of course he sees parallels. The failure rate of great empires in terms of geography is 100%. Just look at Athens and Britain today—everyone has passed the baton in due course. However, there is one sense in which these empires are still with us today. What was great about ancient Greece is with us in the world today—it has just moved. You can be confident that the US will not be the most dominant

and admired country in the world forever. We may have a longer run than most– we may even have a long run ahead. But, we will eventually fall from the top.

But, the US has had a huge, constructive influence on Asia. Asia is important for the future of the world and many people there have learned from the US's experiences. Another person who has been a great instructor to the world is Lee Kwan Yew of Singapore. He helped change China. Where did Lee Kwan Yew learn his values? He was educated in England and was English speaking all of his life. As such, a lot of the culture of this room was absorbed by Singapore. If China becomes the greatest nation in the world, some of our best virtues will be a part of that country as well.

Q26: Do you see a depression in the near future due to high unemployment?

Munger: Employment conditions are bad compared to what we desire. Employment is going to be a problem for a considerable period. But, that doesn't ruin life. He was raised in the Great Depression and it did not ruin his life. A good way for us to deal with the employment problem is gumption. (Gumption is one of his favorite words that no one uses anymore.)

Q27: Is there anything he suggests that can be done to help employment?

Munger: Like Japan had in previous decades, the US has had huge new competition from places like China. This dynamic has reduced employment opportunities. These are very real issues that investors have to take into account. Going forward they have to be wiser than BRK was when it bought Dexter Shoes (and the company soon lost out to cheaper Chinese competitors). Part of the trouble is that the Asians are so talented. They were held down so long because they were stuck in a Malthusian trap—they didn't have enough to eat and now that problem has been alleviated to a large extent. These people now have been unleashed and they have great ambition and culture. We have benefited from Chinese goods being better and better and cheaper and cheaper. But, as a side consequence we have a lot of competition in terms of manufacturing.

Charlie said he is very philosophical about stuff like this. He likes that the Chinese are coming up. He likes what was achieved by Japan's success. Look where car and TV production went—it went to Korea and Japan and away from the US. He can hardly believe the modern products that are developed. For example, his dentist has had at least 4 total equipment makeovers during the years he has been going there. The equipment is so good he thinks even he could use it. The dental assistant now has the modern equivalent of miner's lamp that helps her see better. Now she is less likely to stick something into his gums rather than where she wants to.

Q28: What does he advise for concentrated investors who run pension money?

Munger: Modern consultants with their style boxes and all of the fees are not going to work worth a damn, on average. But, he believes that someone with the attitude and philosophy of the questioner will do better than average. But better than average may not be good enough for certain employers. He would never let pension funds make 8% return assumptions. With low yielding bonds and stocks, how do you come up with 8%? You come up with it because that is what you want. That is not the Munger

system. In his eyes you go through life looking for pain and taking it advance. It makes you a protector of yourself and your employer.

Q29: Which is the company you love the most outside of BRK? What CEO do you admire the most?

Munger: His only other directorship position is on the board of Costco. He is on the board because it is his wish and also because many companies avoid him and wouldn't want him on their boards. He would argue that Costco is one of the most admirable firms in the world and that CEO Jim Sinegal is one of the top executives in the world. Charlie can't say enough about his admiration of Costco. But the world has figured it out and the stock sells at 25x earnings. The world should work that way—finding great places to invest. If you are comfortable with 25x earnings, slow advances, and working with great people, Costco at 25x earnings is one of the most admirable capitalistic institutions in the world. It is a total meritocracy. They pass on savings to their customers as if it were a moral duty. The company is losing money in the short term to make money in the long term. Everyone in the room should go through Costco's annual report. In fact, every time Donald Trump says something and you get discouraged, just think about Costco.

Q30: The question had to do with what books he reads and what he does if he starts a book he doesn't like.

Munger: As he starts regretting reading a book, he starts turning the page faster. But, he is not too burdened by god awful books because he either avoids them altogether or desists after a short time. He passionately read the world's great fiction when he was young. But, he gradually drifted out of it after he knew most of the tricks. He moved to non-fiction for the most part and rarely reads fiction now even for pleasure's sake.

When he was a kid he loved Sherlock Holmes. Then, later in life he read a paperback that included the total work of Arthur Conan Doyle. He found that some of the non-Sherlock Holmes stuff was just awful. The Sherlock Holmes genre was a gold mine. Conan Doyle wasn't even that good—he just stumbled into the right gold mine. However, Charlie likes the idea that he can now admit that what he once admired was not that good. He also likes to better understand how important it is to stumble on the right gold mine.

Similarly, he loves to admit it when he is a total horse's ass. Recently, his country club wanted to tear out a lot of trees at an exorbitant cost and he fought the plan. Now that the trees are gone, he sees that it was worth spending the money and that he was a horse's ass. You take the pain out of being foolish if you take pleasure in rubbing your nose in your own mistakes. It is a wonderful thing to do. You will never lack for opportunities.

Q31: How would you approach selecting an investment manager if you could not see his or her returns?

Munger: It is very hard to do. Tons of people come to BRK who are very high grade investors but picking a manager is not like shooting fish in a barrel. You don't want to find people who will only be really good

if they stick in their niche. Charlie and Warren could scale and that was their advantage. He only knows of one person right now who can scale in that way. He doesn't like the manager's manager concept (funds of funds for example)—too many people and complexities. He is going to leave that selection process to Harvard—an endowment that makes a lot of asinine mistakes.

It is easy to find people to avoid but it becomes tough with admirable people. This is especially hard as the managers get bigger and hire more people. The big investment firms underperform as they get more money. But, it sure is a wonderful problem to be so rich that you need an investment manager.

Q32: Will recent and continuing disasters change the property and casualty insurance industry?

Munger: This business is continuing as it has it in the past—it has always been a mediocre business. Any business where you take in money, keep it for a while and then have to give it back much later will attract a lot of dumb people. The business has no receivables and is very attractive on paper. But, the insurance industry always goes a little crazy. Although, it is not terrible in the way finance is—where people go plum crazy. The casualty business is a very tough business and life insurance is even harder. He then said that the insurance business is currently normal, despite recent awful events.

Q33: What is your perception of how the US will become more adult?

Munger: As Dickens said, it is the best of times; it is the worst of times. For example, people have looked at the energy situation and decided to turn corn in fuel. This is an asinine idea and people are just starting to see how stupid it is. He knew it all along but couldn't do anything to stop it. He mentioned that 20% of BRK's Iowa utility's power comes from wind. Before the world could think seriously about having energy without hydrocarbons, you could be glum about human's future. But now we can be more optimistic—we are likely to have enough energy to face the depletion of certain resources. We are going to have to pay more for things like shale natural gas. But, having access to that gas is a very positive thing. We are going to take a lot of energy through the sun in the future. We are going to have a big national grid at some point. We are learning from China as China is putting in a huge grid.

Many technical problems are solvable if you have power. We will have global warming and man may have some impact on it. But, he doesn't believe that it will be that bad. There are people who like to sit around and think about how bad things will be but mankind has adapted to temperature changes in the past. It has been colder and hotter during periods of time. We now even have the power of geo-engineering. We can change the temperature of the earth if we are not happy about it. We can reflect more light if we want to. He also said that it might be a good idea to have a slightly warmer world. He doesn't see many people moving to North Dakota from Southern California. Also, there is a lot of land in Canada that could be much more productive if the world warmed a bit. He likes the work of a guy named Freeman Dyson on this subject.

Q34: Jeff Ellis of UCLA Anderson and West Coast Asset Management- Questioned about the role of the Chairman when Buffett dies. Would Bill Gates be a better Chairman than Howard Buffett?

Munger: Would not comment on whether or not one of Buffett's sons would make a good a Chairman.

Q35: Victor Liu of Causeway Capital- Does he favor public school or private school education?

Munger: Public schools are now nowhere near as good as private schools like Harvard Westlake. He wonders how much better he would have done if he would have gotten an education for Harvard Westlake instead of Omaha's public schools. But, he thinks his public school education was good enough. He thinks he would have forgotten calculus quickly in any case—it wouldn't matter when he learned it.

In the end you need to get a certain baseline education for a child. But, dragging a kid a few years ahead can be problematic. He was obnoxious enough as a kid as it was. He thinks it is worth it to push the best modern schools. He wants to see how good we can make our system. But, whether the students who graduate from these schools will have a major advantage is unknown. What he does know is that there are a lot of defective college students. Kids who come from great schools just run rings around them.

Q36: What advice does he have for judging good management?

Munger: Judging the management at a company like Iscar is easy—those people are enormously talented and wonderful. But, there aren't many managements like that and few people with the incentive of such intensity. Failure is not an option in Israel—they have no hydrocarbons and enemies everywhere. It is easy to judge great managers.

On the other hand, he knows of a company with a great culture and a great business and he and Warren admire the guy who runs the company. But, the man just made an awful acquisition. Charlie believes that you have to be willing to be disappointed by managers. All managers are going to drift. If he and Warren could be so wrong as to buy Dexter Shoes then we should not be surprised that others make acquisition mistakes. If you are not frustrated by what you see, you don't understand it.

Q37: US Bank (USB) and Wells Fargo (WFC) have done better than other banks but could get pulled down by bad actors in the industry. How can they avoid that?

Munger: No one can 100% stay away from trouble. However, companies like USB and WFC are better at avoiding the common stupidities of banking than most. BRK doesn't get to have perfect managers either. There is always a compromise—like what his wife did when she married him. They have to deal with what is available. He knows people who will not own financials because they think the banks will go crazy. Charlie knows this is not an irrational statement. But, he likes that these banks acknowledge this problem. Bankers from WFC admit that they had their heads up their asses when they made a lot of 2nd mortgage loans.

Look at the troubles that Bank of America got into. Talk about a disgrace in terms of decision making. Of course there are risks with these companies. But, manufacturing companies are not perfect either. His life expectancy is not what it used to be but he is still here relatively cheerfully. Would it be better if he were on the floor sobbing about it?

Q38: The question was about the prospects for Level 3 Communications?

Munger: He said he didn't know much about the company. People build too much fiber optic cable just like they built too many train tracks in the past. They then got the same outcome: a huge contraction. He has never looked at Level 3. He has three folders on his desk—in, out and too tough. Level 3 fits in the too tough bin.

Q39: The question was about Ben Franklin's role in his life.

Munger: Franklin said something to the effect of: "When the citizens of the world find out that they can vote themselves into money, they end of the civilization is nigh." People now act as if they need it, want it and deserve it (money and power that is). These are pathetic adults acting like children. If Franklin were alive today he would highlight this issue. Our ancestors limited this by only allowing property owners to vote but we are having trouble with it because of our voting rules. He used to ask why everyone should vote. He has always opposed mandated voting because he thinks it would actually hurt the civilization if everyone voted.

Munger's response to the applause at the end of the Q&A session: He liked the reaction he got and the great turnout as opposed to the huge turnout the dead man gets when people show up to the funeral just to make sure he is dead.

Daily Journal Corp Annual Meeting Notes (Feb 6, 2013)

Charlie Munger: and this building, which, of course, is on a site that we cleared old buildings off of. You have the Tilmet Building (sp?). That was very cheap to construct. You can look around at how nicely it works. It's a very inexpensive building. It has high ceilings and good lighting et cetera.

First, we'll talk briefly about the Daily Journal business. And, of course, the Daily Journal is really two businesses. It's the traditional...Well, it's really three businesses.

First, it's the traditional information-providing newspaper for lawyers.

Second, it's the newspaper that publishes a lot of public notices that are required by law, which is where a lot of the money has been made, of course.

And third, of course, we have this relatively new software business, which is really a form of venture capital since a lot of meaningful money has not been made, and a fair amount has been lost from the two businesses that are now combined.

The traditional information business is suffering tremendous headwinds. This business made a lot a money out of lawyers' subscriptions for a long time because there was no way a lawyer could get information about the recent decisions in, say, the appellate courts in California and the federal appellate courts in California except by picking up the "Daily Appellate Report," which we included in our newspapers.

We had something that lawyers had to have, and there was no way in the old technology for them to get it on time except through our newspaper. When the electronic stuff came, the lawyers were all trained to use electronic media to keep up with the courts.

And the new lawyers coming out could hardly do anything else but pound keys on a computer. It wasn't good for our traditional information model and our subscriptions continue to shrink year after year after year.

The public notice business, of course, is an ancient business. The old technology where the law wanted people to have some public way of getting notice and the only way to do it was with a printing press. They passed all these laws. The people who pass laws have not been quick to change from the old printed method to the modern post ink and storage basis, accessible by computer.

And that has preserved revenues from the old business, and then you had the foreclosure boom, of course. There was a torrent of revenues. I don't think there ever was a foreclosure boom -- let's call it a boom, it was a boom for us -- as big as the one we've just been through.

There's never been anything like it. And it's not over. There's still a considerable pipeline of underwater homes. Of course, it's through the press. That's the traditional business. Of

course, we've made an unholy amount of money out of the public notice business, which I do not regard as a business I would bet on for the next 50 years. In other words, it's got a Sword of Damocles hanging over its head, and the traditional print business presents a very interesting problem.

Of course, practically all newspapers in America have faced the same technological revolution from changing technology, and the standard result has been an enormous impairment of the business that was a total monopoly for most proprietors of the only daily newspaper in a city or community. They own the world. An idiot could make money, and a man who's half-way competent could make an enormous amount of money.

The by-product that happened with that, and that with all this impregnable economic power, the people who controlled the newspapers, influenced by the ethos of the journalists that worked for them, by and large behaved pretty well. Whether they were Republicans or Democrats, and they got … the fourth estate. They helped run the country.

Here was a totally independent part of the governmental system in functioning actuality that served very well. That's why they call it the fourth estate. Nobody who created the Constitution had any thought of deliberately creating local monopolies. That we would have a separate branch of the government that just sort of arose through accident and had this enormous power, but that system which evolved by accident served this country very well.

The daily press with all its power is by and large civic-minded and honest all through the country, and of course, it's horribly threatened. The country is going to pay a terrible price for losing this constructive influence. … isn't like we don't have any other journalism, but I think that we are losing something.

We never used The Daily Journal, which you people own part of, as a mouthpiece for our personal political opinions. For one thing, we didn't have an impregnable monopoly. For another thing, we just didn't want... we had very intelligent readers, judges and lawyers. Half of them were in one party, and half of them were in ano**ther. I don't think either Rick or I felt at all comfortable telling somebody else what we thought on every subject as if we were God, and so we never did it.**

I also think that was the best business policy. We always wanted the paper to be trusted, and I think it by and large is. I think the judges and lawyers who read it, they don't think we've got some crazy personal agenda. We're trying to tell it like it is. That's, of course, the ultimate, correct journalistic ethos.

How people cope with a technological revolution is interesting. A great number of the great collections of newspapers borrowed a lot of money to buy more papers. They like monopoly and they like to buy more of it on credit. When the technology changed, two or three or four of them got hung out to dry. That basically destroyed the entire common equity of the shareholder. That happened at a lot of places.

Even places that are super-strong like The New York Times destroyed an enormous amount of equity by paying a billion dollars for the newspaper in Boston which now makes no money at all, in fact, is probably losing.

There's been a lot of agony in the field. Around here, all we ever bought was other public notice rags. We bought every one that we could find, occasionally, one case at least, in another state. Did we ever buy anything except Arizona out of state?

Jerry Lee: We bought one in Denver.

Munger: Yes, all right, two. But we bought these public notice rags. They were slightly incremental, and they had this embedded option in case there was ever a flood of public notices and the action was for free, so to speak. That's the way the average real estate gets rich when he does. Somewhere in his operations there's an embedded option that he really hasn't paid for, and the harvest in due time comes, and that's what happened with us. Jerry was unbelievably good at dealing with all these little proprietorship, where a man and his wife to be making $60,000 a year running a little paper. We bought a lot of them.

Lee: Plus Phoenix.

Munger: Plus Phoenix, and Phoenix was just ridiculous. I don't know how many percent per annum we made on that investment. It was thousands. I think thousands of percent per annum on the investment. I don't know how much credit we do get for doing that, but at least...You look around these other newspaper companies which have either had this horrible contraction of earnings, or they've gone completely broke. Here we are with...We're still making money out of the public notices and we've got all these marketable securities, which we bought using the proceeds of our public notice boom. **We're like the fellow who had a funeral parlor, and there was a plague.**

Well, you can laugh, but that's what happened. The Texans have a marvelous saying about the people who get rich by accident and think they're geniuses. They say, “Well, old Charlie was out in the field playing the big bass tuba the day it rained gold.” That type of saying to some extent applies to us, but to some extent we were pretty true in running around and scrambling for these minor little properties, and running them intelligently and coping with the problems. I think we can fairly say that we did not anticipate a harvest like the one that came.

Of course, many of you are come here because you're investment groupies. You're not really Daily Journal shareholders.

You're addicts. You're addicts to a certain attitude toward life. It's not that large a group, but you're pretty badly addicted.

At any rate, that's the thing. Now, the software business is something else. I think you would argue correctly if you said, “You never should have bought the first one.” It looked a little bit like a pre-op showing. Spend a few million dollars and maybe we'd get a position which enabled us to have an unusual access to data that lawyers would want and so on. We had various little theories. Of course, the theories didn't work out, and we

kept getting sucked in to perfecting a software system by paying other people by the hour to make it, and we lost quite a bit of your money in our first venture.

Now, we're still losing money, we've just doubled down. We've bought another company, which is about five times our size in terms of actual revenues. But it's got a much better sales team and a much bigger installed base than we have, and we really like the people. We instantly liked and trusted the people. I don't think you'd like and trust everybody in the modern software business.

In fact somebody ran a public search recently on the name of one of the leading software titans of the world with a deep profanity attached and said, “Can you find any double hits,” and of course there were so many double hits that you couldn't believe it. So software is not a perfect business or an easy business or anything else.

You people have the declining remnants of the top tick of an old information business, the newspaper, and this pile of marketable securities, and this very interesting software play, which is like venture capital.

Most of you did not buy the Daily Journal company to get this particular outcome, but we didn't set out to create this outcome either. It just happened. **Therein lies a lesson in life. I think most lives work best when you simply react intelligently to the opportunities and difficulties you encounter, and just take the results as they fall.**

Some people think that by master planning, you will solve everything, but what I find is that the master plan gets a life of its own, and people believe it because they previously decided on that then, and they make all kinds of mistakes.

(Thomas) Carlyle was a very smart man, and one of his favorite sayings was, the task of man is not to see what lies dimly in the distance but to do what lies clearly at hand.

(Ed: actual quote: “Our main business is not to see what lies dimly at a distance, but to do what clearly lies at hand.”)

It was that message from Carlyle that caused Sir William Osler to create the medical school, which became a model or revising all the medical schools of the world, which was Johns Hopkins.

He didn't have a master plan for Johns Hopkins. He just reacted to the opportunities and hazards of his time as best he could. And lo and behold, we got the leading medical school in the world.

Incidentally, that wouldn't have happened without money from Carnegie and Rockefeller. So the robber barons of old, when they set out to do charity, were some of the most effective givers in the history of philanthropy. Rockefeller's $50 million, in the course of two or three years, completely changed medicine in America.

They drove all these charlatans out that had one pill for everything from cancer to impotence, and none of it worked. They drove out a lot of people who should have been driven out, and they caused modern education and research establishments to be created.

There's interesting precedent given the strength of the Johns Hopkins system and Carlyle's basic idea, and based on that we have a certain modest prosperity in spite of being through an enormous headwind. And our basic business I think demonstrates that Carlyle might not have been wrong at all. To the extent that any of you have problems in your life, this enlightened opportunism and this resolute desire to fix problems as fast as they come up, which Jerry's a genius at.

Jerry's fixes what's wrong quickly, and he runs down opportunity quickly.

That's what we've been through with the Daily Journal, and it's interesting to us. Neither (J.P "Rick") Guerin nor I have taken one penny out in all the years we've been invested, and you can see this is the ultimate...What would you call it? Are we misers? I don't think so. Guerin was like a prince.

I don't look too badly myself. But we're certainly willing to go through a lot of self-denial, and we really want people we scarcely know who just happened to buy this stock to do well and that isn't true at a lot of places.

They talk the talk, but they don't really walk the walk. I don't think many people who work in the executive ranks of General Motors or have served on its board of directors have any feeling of guilt that they destroyed 100 percent of the common equity, starting with the strongest company in the world.

But we're not like that. We would feel terrible loss, but we don't mind taking you through a little hell on the way. But we want you to come out all right if you keep the faith. That's the culture, and I don't think that's going to change.

Anyway, that's the Daily Journal. Jerry, do you want to say anything to this group?

Lee: No, I'm fine.

Munger: All right. Now we'll open the meeting to questions. Yeah.

Shareholder: Why double down now?

Munger: That's a very good question. You could argue if we were poorer and meaner, we wouldn't have done it, but we admire the people whose firm we've just bought. We admire the people running it. We feel it's at least a decent gamble. I have no feeling I'm just deliberately wasting money. I'm just taking a gamble I might not have taken if it was the last money I had on earth. I think that's probably what we should do. We employ a lot of people. We're located in the state, and it would be very helpful. There is some chance of it working into a bonanza. Now it may be a small chance, but there is some chance.

What is interesting about this, for legal information, those of you are students of capitalism, it was a duopoly in the legal information field, including the electronic stuff.

One was Reed-Elsevier, and the other was Thompson-Reuters. These are two very powerful places.

Reed-Elsevier got rich on one of the greatest business models ever created.

They published scientific journals. They didn't pay a dime for the content, because people want to be published. Didn't pay a dime for the reviewing and editing, because the people wanted to do the reviewing and editing as part of their duty to science.

With content totally free, they published the journal and every library had to buy them, and every leading scientist. It was just a total racket, and every year they raised the price by 15 percent. Of course, they could then buy all these other papers. You could say, "Why didn't we start in scientific publishing?" Well, the accidents of life didn't present us with that opportunity.

But what's happened there is that duopoly has suddenly gotten a new entrant, which is Bloomberg. Bloomberg is worth tens of billions of dollars and drowns in money, and has a total monopoly of its own with which it can use to do what it damn pleases to try and take territory. It can behave a lot like Amazon if it wants to, where it just takes territory from incumbents by brute force.

Now we have a three-way race, and it's interesting. You guys are professional investors. It's hard to predict which nice, comfortable two person duopolies will suddenly become a gas leak and competitive miasma. It just happens. Who would have predicted that Bloomberg would have charged into legal publishing? It has, and it's no fun for the incumbents. You do have this unpredictability in American competition, and it causes weird results.

You give me that question, but I think our chances were good enough to justify the investment, but I don't think we would have made it, if it was the last dollar we had on Earth. We're not ashamed of it. We're glad we did it. We may win. We're certainly going to try. Of course, when I say, "We're going to try," I mean, "They're going to try."

Munger: Any other questions?

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Shareholder: Do you have any thoughts on how the legal challenges to the ratings agencies will work out?

Munger: That's a very interesting question and very topical. Up till now, the rating agencies have avoided any big loss from judgments. Their attitude is that they know how to sell guarantees that securities would be paid off and they weren't selling guarantees. They were selling opinions. Their attitude is, you want a guarantee, you would have to pay for it but a lot more. All we gave you is an opinion and as long as we believe their opinion and weren't deliberately lying to you, you can't recover.

That's probably a correct explanation of the law, but if you ask for a jury in their embarrassing emails and so on, this can be quite expensive. There isn't any doubt.

Both of the rating agencies have admitted to serious mistakes in judgment. Of course, those mistakes in judgment were undoubtedly contributed to by the fact that they're re-paid to do all this.

I personally don't think they were consciously lying. I'm not saying there wasn't a one person there somewhere in our organization that may not have liked his company's product, but I don't think they were consciously doing it.

They were stupid and one of the reasons they were stupid is the self-conscious selected their own interest. It's a serious bit of legal trouble. All I can tell you that I don't think anybody's ever paid any big money on this area before, but you do have embarrassing emails and so forth.

Generally speaking, the emails are great for lawyers. The record is permanent. You have an army of people. Somebody's going to say some dumb thing and you can get that dumb thing before a jury. Maybe you can make some money or browbeat somebody into a big settlement.

Which gets into the question of should young people be creating these permanent paper records on Facebook, and so on of the dumbest thing they ever did or thought, so it's immortal. I think it's insane. I would hate to have to read the dumbest things I ever said at fifteen years of age -- it would be embarrassing for all of us, at least it would be embarrassing for me.

I don't like the way the world evolved on that. I do think the rating agencies use very poor judgment. I think the people that were issuing the bonds, these are really smart people, much smarter people than the people in the rating agencies.

Of course, they paid tremendous penalties. Some of them have gone broke. Others have given them millions and millions in settlement. You'll reach impairments in reputation, so on and so on.

What happened in the boom and the lousy credit and market spiels, packaged up into lousy securities, mis-rated by mistakes by jerks who believed in mathematical formulas instead of common sense. It was not pretty. People paid a terrible price for it, and the country has paid a terrible price for it. I can't predict what's going to happen in the litigation.

I can say one thing, the rating agencies would have been way better off if they'd made less money, had been more careful, and thorough, so the extent any of us have decisions to make. Foregoing money, because it's sort of tainted, or too close to tainted, or too close to gaming, is a very good thing. Sol Price (founder of Price Club) used to say, success in business came from deciding which business you could intelligently do without.

He had a list of business he didn't want. Those things he didn't want -- he didn't want business from people who wrote bad checks. He didn't want business of people who shoplifted. He didn't want business of people who clogged-up his parking lot without buying very much. He carefully invented a system where he kept those people out, and

succeeded by deciding what he would be better off without and avoiding it. This is a very good way to think, and it's not all that common. It's, perfectly, obvious, isn't it? And it has been of enormous help to the people sitting at this head table. But most people just aren't trained to do that — if it's more business, they tend to want it.

There's enormous money and happiness, and better service to be gained, by just deciding, “I'm going to do without that.” Warren used to say, when we were brokers at Solomon, “I'm waiting for a list of the business that we have declined because it was morally beneath us even though it was legal.” People are just so competitive they just want to do every damn thing that can be done, profitably, whereas, we need something beyond that. I'd imagine, he'd behave, just slightly better, than what would take him to prison, in order to get money.

You should have personal standards that are way better than the criminal law requires. Why should the criminal law determine your behavior? It would be crazy. Who would behave that way in marriage, or in partnership, or anything else? Why should you do it in your general dealing?

I think this mess, and, of course, it's a little dispiriting to find that many of the people who are the worst miscreants don't have much sense of shame and are trying to go back as much as they can to the old behavior.

The truth of the matter is, once you've shouted into the phone, “I'll take x and y,” and three days later, you have an extra 5 million, once that has happened, the people just become hopeless addicts, and they lose their bearings. You can argue we shouldn't allow a system where that can happen.

Look at the people who get addicted to poker, both online poker and gambling parlor poker. A huge crowd of people, 50, 60 hours a week and grinding away at these tables, of course somebody who's making croupier's profit off the top, and the very shrewd people are taking away money from the less shrewd people. Is this really in the public interest? I don't think so.

Even if it were in the interest to allow this recreational poker, to turn the public securities markets into a very effective gambling house for the people who think like the poker addicts and behave like the poker addicts — if I were running the world, I would put a lot of people out of business, including several in this room. In other words, I don't think you necessarily want a huge class of people getting rich in software by being a little cleverer than other people.

Shareholder: Two questions, if you don't mind. From 2000 to 2008, Daily Journal seemed to reinvest nearly all of its profits into US Treasury notes and bills. In the last two years, after February 2009, Daily Journal has invested over $30 million into common stock of three companies. Can you discuss the difference between the investment landscape over the last few years versus 2000 to 2008?

Munger: Well, when we're engaged in something difficult, as we were with our declining main business, we tended to want extra reserves of strength. As we got so much

extra money and the opportunities in marketable securities got more extreme, we changed our point of view as the facts change.

Keynes used to say, "When the facts change, do you change your opinion?" *(Keynes actual quote was: "When the facts change, I change my mind. What do you do, sir?")* Well, of course you do. That's what we did. Our circumstances were different and our opportunities were different, so we behaved differently. What would you do?

Shareholder: Is it any reflection of the investment climate, or purely...

Munger: Yes, of course, that was part of it. The price you pay for some of those securities was ridiculously low. In fact some of that stuff was something that happens once in 40 years or something. Who in the hell keeps money sitting around waiting for one of those opportunities? (A) It might come and go and you may not recognize it, and (B) what do you do during the 40 years you're waiting?

So I don't think you should be terribly encouraged by what has happened. It doesn't indicate that suddenly a recurring stream of money going from people in their 90s. It just means that for one reason or another, we behaved pretty sensibly, and reacted pretty intelligently to opportunities. Other people didn't do it.

General Motors, out of the profits of their good years, they could have bought, every year, for many years, a big company. They could have bought Eli Lilly one year and Merck the next, and United Technologies. General Motors could own the world. Instead, what they declared to their shareholders was a goose egg. They took the common equity to zero. And they would say it was all somebody else's fault. The climate was bad, the unions got powerful. Those damn Asians and Europeans were too competitive.

The truth of the matter is, their very prosperity made them weak. The dealerships got in the hands of inheritors, and the executives on the sales field, they go around and drink martinis with inheritors, and didn't pay enough attention to defects in their vehicles. And one thing led to another, and when they were all done the shareholders' equity went to zero.

And that was in a company that at its peak was one of the most admirable companies in the world. Take the stuff that Boss Kettering (Charles Kettering - head of research at General Motors from 1920 to 1947) had invented in the early days. Kettering was one of the most useful citizens that ever lived in America.

A self-starter on a car is a wonderful thing. Under the old system, you frequently broke your arm. You would give it a crank and it would answer back by spinning backwards and breaking your arm. I would much rather push a button than have my arm broken. Nor do I have the opportunity to go and crank in the sleet and snow.

Kettering did a lot of inventions like that. In the early days of General Motors, they really made some enormous contributions to civilization. And they are still making contributions, but it is so competitive.

I should tell you people a story, because you are groupies for stories. I talked recently to a man who shall go nameless. But his company was one of the great growth stocks of America.

And they had armies of PhDs in there who had mastered very difficult disciplines. And they had patents, and technology, and know-how, what have you -- and hard-to-replace plants. What they make is difficult to make in a lot of different categories.

And the profits in the business are very mediocre, to put it mildly. And it isn't that it has been that badly run. It's just that everybody's learned how to make these difficult things, and there are too many of them trying to make them. It just gets terrible. And what happens then is, you're now the CEO of the place and you see it's getting tough. Your duty, your acquired self-image is a guy that knows how to fix things. You never have a category in your mind of, “It's too tough to fix,” which is a really stupid idea. You can recognize all kinds of things that are too tough to fix.

But if you don't, then you are a sucker for some narrative to say, maybe there's some company in your industry that makes something really complicated that other people can't match. And you say, “Well, I'll buy that. That solves my problem.” But your friendly investment banker and your friendly management consultant want you to buy it at 30 times' earnings and 12 times' book. Of course, at that price, it won't solve your problems. And you do it anyway. After all, you've got consultants, and it gives you hope.

Many of these people buy things the way that people used to go Mexico and ingest apricot pits when they had pancreatic cancer. They wanted something that provided hope, and so they believed in apricot pits. A lot of American industry helped by their friendly investment bankers and consultants of other kinds, they want to believe that in this terrible, tough business, there's an easy solution. It just requires listening to the siren song and writing the check. Of course, usually it doesn't work.

The ordinary acquisition in corporate American does not work for the shareholder. In other words, on average all the acquisitions together are anti-shareholder. Only occasional ones work, and work well, and it is rather interesting that Berkshire, on average, they work pretty well.

What is the difference? Why are Berkshire's acquisitions, why are they averaged out so well when we pay the prices for whole companies, and the standard experience in America is that the acquisition doesn't work that well.

There are a number of reasons. Partly they're that people like buying in their own field? As to a field that is prosperous like newspapers? They keep buying up higher, and higher prices to encourage everybody wants to buy the same thing, so you get in a very bad daisy chain that is anti-shareholder.

In its places where you want to believe that there is a simple way to buy your way out of trouble. Why should it be simple to buy your way out of trouble? You get a little pancreatic cancer, are you going to buy your way out of trouble?

I don't think so. There are all kinds of things you can't buy your way out of. You have to adapt to them. Part of Berkshire's secret is that, less than most people, we don't pour endless treasure into losing hands, on the theory that we're going to win and do it fast.

Berkshire got though this helpful reputation among their group of addicts over a long period of time. It took a long time. It's a very useful, useful thing to have. Two, I think Berkshire's been blessed with these big insurance companies. It's got two things to do. It can buy companies or it can buy securities as insurance companies. Aren't you going to make better investments, if you can get two reasonable options at all times instead of one? Doesn't that make sense? That's another of the reasons.

I don't see why Berkshire isn't more copied, except I think people look at it and they look at their culture with its own traditions. They came to power at 58 they're going to be gone at 63. They don't see any way of getting from where they are to where we are.

How would you change DuPont into Berkshire Hathaway, if you were the CEO of DuPont? It's addicting. I've got right to give up on the problem and not even think about it. At any rate, I do think of it as peculiar. This acquisition business — It's generally a tough game.

Shareholder: I had a second question. The second question was you had mentioned talk about doubling down on the New Dawn acquisition. In 2012, the company also added a supplemental addendum to management incentives, where management should be compensated should Sustain be sold or IPO. I was curious if there's anything that we should think about if Sustain were a standalone business, if it could have value to another owner that exceeds what's currently being suggested by the current financials?

Munger: Well, of course Sustain could eventually...Sustain and New Dawn, I'm a total convert to the new product, of course, I think if we've succeeded, that would be valuable to other people.

As it is now, it's not like ordinary software. The people like Oracle and Microsoft, and never wanted to be a mixed businesses too awful. The RFP, the consultants, the bureaucracy, it's just agony squared, agony cubed. And they like easy money, and they're right, too.

We generally chose this hair shirt, and it is agony and it is hard, but it's challenging. Eventually, if we succeed, it will do a lot of good in terms of service and efficiency and so on. We went the unusual incentive program, because everybody in software expects some carrot so we were just bending to the wind in the field, really. That explains that.

Shareholder: As a fellow addict, I wanted to comment and then a question, and that has to be why so many people gathered to hear a 90-year-old. I'm reminded of the difference between knowledge and wisdom. We're here for wisdom. Knowledge is knowing the tomato is a fruit, but wisdom is knowing not to put it in the fruit salad.

Munger: Well, I think there's some truth in that.

Shareholder: So we hear from the liberals that have commented on had to do with paradigm shifts in management styles and is that the goals in management should be... I'd like you to apply that to the government, because I think the elephant in the room that I haven't heard that, is all of us share a concern for the leadership … and the consequences of the decisions

Munger: Well, of course, if you take the whole history of government in the world, it's a pretty sad story. Think of all those years of crazy kings, crazy theocrats, the holy inquisition, populist mobs — Imagine the French mob that cut off the head of the greatest chemist in the world, Lavoisier (Antoine-Laurent de Lavoisier – the father of modern chemistry).

If you look at the history of government in the world, you see just a lot of crazy — Think of Mao killing 20 or 30 million people on some dumb idea about farming. There's been a lot of horrible... Think of the whole Soviet Union getting so they provide perfect job security. Everybody had a job. The way they described that was, "They pretend to pay us and we pretend to work." And despite what's been working for every else the Soviet Union (didn't want to use that.)

The whole history of the government has been bad. Of course, our founders realized there were dangers buried in democracy. It was Ben Franklin who put it in "Poor Richard's Almanac," he says, "When citizens of the Republic learn they can vote money, the end of the Republic is nigh."

Well, not that near, but it's a very dangerous thing that you learn you can vote yourself money. What's safe unless everybody's working their way toward productivity and success. Just ganging up to vote yourselves, money is dangerous. When it's carried to excess like Greek culture where A), everybody tried to vote themselves money instead of doing anything else or B), so they succeeded from paying taxes or anything else, you're talking about a very dysfunctional society.

It's not as dysfunctional as the Soviet Union. After all, the sheep farmer in Greece probably was pretty efficient at tending the sheep. In the Soviet Union, nothing was efficient, except the high science. Get a bunch of high IQ people together and give them problem sets -- why, you can do that as well in the gulag as you can do it somewhere else.

But short of that, why...I can't fix the problems of government. There's so much that's good, including in government, but I think it's probably a mistake to concentrate too much on what's awful but certainly a lot of intelligent people are a bit discouraged by a lot that's happened.

But you wouldn't have liked the politicians of yesteryear. They built the transcontinental railroads with Congress taking cash bribes from people like Huntington and Stanford. They got the railroad built but it wasn't pretty.

People were cheating the government way back. The Civil War was full of lousy products sold to the soldiers. I can't think of any much more heartless. Remember the local druggist who diluted all the cancer drugs so they could make more money. Imagine doing that — That was routinely done in the Civil War by respectable manufacturers. They just cheated the government troops.

There's a lot of unhappy occurrences in the history of man, and there's a lot of peculiar government...If you go back to where government was simpler and more honest, then 85 percent of the people were on farms doing backbreaking labor and they could never leave the farm or leave the farm or read anything or see any athletic events. I'd rather have a little sin and not be doing brute labor on the farm.

But at any rate, I can't solve your problem. You're right to be concerned about it. But if you also look around, you'll find example after example of fabulous good government and various institutions, both private corporations and public. I'm very much impressed with the way they run the University of Michigan. It's a tough hand at the state when there's nothing but economic squeeze for all a long time. That University has gone up, up, up, better loved, better respected, better serving. If you look around, you'll find much that's good in human governments, as well as bad.

Shareholder: what is the company doing today different from yesterday and that could be reflected in the picking of the right software?

Munger: We bought New Dawn, which has a way better sales culture than we have and a bigger installed base and we like the people. That is very different.

Shareholder: Is that proprietary?

Charlie: Well, meaning is it a cinch that we will win? The answer is no. Is it quite possible that we will win? The answer is yes. But it's quite different. Yeah?

Shareholder: If you're design a proxy statement and you're trying to think about a couple simple long term metrics to incentivize management. What would you think about?

Munger: Well, if you want to talk about that subject, which is really interesting from your point of view... you have touched a real nerve. What has happened, of course, is that institutional money management has been hooked with the aid of these consultants, whom I can't stand.

So everybody wants to raise the indexes and they've got 50 different indexes, but everybody's racing an index. The monthly statement shows how you performed that month in relation to the index. Your shareholders who'll make the decision as to whether or not to buy the stock are institutional money managers and they're worried about not losing assets and fees that are related to the assets from getting behind the other people?

That is a dysfunctional, stupid system and it gets stronger and stronger with every passing day. That is a serious problem.

I don't think little changes in governance are going to fix something so awful. These people are locked in this horrible system, all the participants, and they can't do much about it. They have to live there. They've got a wife and children and a mortgage, but they have to live in the system they're in.

It's not a pretty system. The people who are profiting from it like it the way it is. It does cause extra action in terms of brokers' commissions, and so on and so on, and more fees and more different kinds of investment vehicles.

It's the same thing like the apricot pits for the cancer sufferer, or the guy who acquire his way to wealth, having failed in his basic business. If it doesn't work, there's a new investment vehicle, a new technique. There's a bunch of Pied Pipers who are always selling some new thing that everybody can try.

It's a crazy, dysfunctional system. In a better world, we wouldn't have all those incentives to make money on a short-term basis. To have everybody engaged in trying to out-think everybody else about what's going to be bought next or be fashionable next, is a very dysfunctional system.

I don't think you are going to have great improvements in governance by tinkering with the rules about proxies, when the whole damned system is fundamentally flawed, when people have these perverse motives.

I look at the votes on these. Everybody votes with ISS (all these institutions) and they've got formulas, and what they are is pro-takeover. If you're a money manager, and you get four takeovers in a year out of your portfolios, that may be the difference between fired and not being fired.

So, the institutions like takeovers, but I'm not sure we want everything in America taken over by Carl Icahn.

Would that be a great outcome for the country? I don't think so.

I think the whole subject of proper governance is a really important subject, but I would argue that the compensation system is crazy, the institutional money-management system is crazy, and the rewards system is quite unfair in many cases. People are voting themselves money they're not entitled to.

It's not a good system, and I don't think there's any easy fix. Well, there is an easy fix, but it's not one that would be easy to get through by vote.

Shareholder: Markets are making five year highs, what do you think …

Munger: Well, I'm not shocked that the market goes up after a long period after which it has gone down, particularly with long-term interest rates that are practically zero. I'm not surprised. That's one of the reasons that they would journalize a bunch of securities and whatnot. That doesn't mean that we've reached the hog-heaven condition for the investor. It just may mean that common stocks are a better bet than long-term bonds, but that doesn't guarantee wonderful results for everybody in common stocks.

I think the idea that everybody is going to have wonderful results from investing is inherently crazy. Nobody thinks everybody is going to have wonderful results from playing poker.

In the end, the wealth of the country is based on the productivity of the country, which only advances so fast. Of course, if you pay more and more people for not working, it's hard to see how that grows the productivity of the country.

Shareholder: You talked about modern institutional money management. How would you contrast that system with what you were doing in the late 1960s, your mindset and how you went about your business?

Munger: Well, there were some delusions we avoided. Other people thought that you hired very intelligent people, who'd worked very hard to learn their trade and taken tests making them certified whatevers, and then you organized them into specialties. One guy would study chemicals, one would study autos, one would study this and that. So, you had 100 different specialists in 100 different fields, all with high IQs and all working very hard, that they could invest in big common stocks using this wonderful system, and gain an advantage over other people.

There's only one trouble with this idea. It doesn't work. It's just too competitive. Too many people are trying to do the same thing. We had a different idea. We always thought that a good investment idea was hard to get, usually, and that by working hard, you might get a few of them.

We never had the idea that just by hiring smart people, we could be good at understanding 5,000 different securities or even 100 different securities. I just had the idea that maybe we could find a few, often enough so it would serve our lifetime needs, and we were patient and we waited and we occasionally made a few investment decisions.

In my personal accounts, guess how many securities transactions I had last year.

Zero

We are not normal.

Can you imagine trying to run an investment management operation with transactions of zero? Anyway, we do have differences, a few decent places. What do the Munger's own? They own Berkshire, they own Costco, and they own a bunch of Asian securities with a guy who's like Charlie Munger born again, except he's younger (presume he's talking about Li Lu). Do I need more diversification. But if you went to the average school in your district and said, "Is this a suitable investment decision?, they'd say the man who made that decision is crazy. That is not the way to intelligently invest money. I guess I just give all the money back. I didn't do it in the right way.

But it is the right way. It's the other people who are wrong. If you want to get rich, you'll need a few decent ideas, where you really know what you're doing. Then you've got to

have the courage to stick with them and take the ups and downs. Not very complicated, and it's very old fashioned. Haven't I described (Rudyard) Kipling's poem, “If?” “If you can keep your head when all about you are losing theirs,” and so on and so on, and if you do this, “You'll be a man, my son.” I think Kipling's poem, If, is a great poem, even if it did come from a man who has somewhat irritated the English departments of the world by also saying, “A woman's only a woman, but a good cigar is a smoke.” He's not politically correct. He was right — So, I'm saying what still works is “if.”

Shareholder: Quick follow-up there...

Munger: It's very old-fashioned. How could you teach it in business school? They teach that you have to have reverse rotation, sector rotation, God knows what in the hell they were teaching. I never paid any attention. Zero.

Shareholder: You talk about patience and long periods of dullness.

Munger: Yes.

Shareholder: What did your process look like back then at Pacific Coast Stock Exchange on a daily basis?

Munger: Oh, we had specialist but somebody else was doing that. I wasn't making those decisions. That was just grunt work to make a little money, making a market. In those days, we were opportunistic and needed a few things. When we had a good idea, we went at it rather heavily. Sometimes we would actually trust an individual.

When I went into that deal with Diversified Retail, that was one of the dumbest things that Warren and I ever did. We both went in on four department stores in Baltimore below the liquidating value of the company, Ben Graham style. We bought it half using bank loans from local people. I remember my share. I had 10 percent. It was $600,000.

As the ink dried on the papers, we realized how ghastly the competition was, and how much capital to operate a department store, and that we were not that much better or different from the other stores, and that maybe department stores did not have the world's greatest future. At least we had enough sense to quickly change our minds and managed to scrabble out of that having lost a few hundred thousand dollars out of $6 million we put up.

But in the course of doing that, other opportunities had come to us, and we borrowed the $6 million with no covenant. Now we had a huge panic. So we use all this capital, including the borrowed covenant, to buy all these ridiculously-priced securities, including some of our own. And so that failed, stupid investment, if you traced it through, it's so many billions of dollars of Berkshire stock, you can hardly believe it.

To some extent, it requires scrambling, it requires the ability to change your mind. At least I'd chosen my associate. I thought that I had an associate that thought he could fix this department store. Warren never had one second — The minute he recognized what we were in, we both wanted out, which was the correct solution.

So all these things are lessons to you, but it's this old-fashioned stuff that really works. Now, I don't say it works to create a Money Minute, unless you have one like Mohnish's (Pabrai), which is a copy of the Berkshire Hathaway system down to the last comma.

By the way, he's rich and happy. Look at him.

He copied a good system. How many people do? There are not that many Mohnish's. The system still works. You can even use it to create a money management business. You've got a man right in the front row who demonstrates it can be done.

Shareholder: Could you give an example of an investment decision …

Munger: Well, I don't want to rehash the old investment decisions, but I'll rehash a failure, because I believe in rubbing my noses in failure. Some of this is in Poor Charlie's Almanac. This is one of the dumbest investment decisions I ever made. After I'd wound up (the Munger investing partnership), I was a well to do fellow, but I wasn't, which I really wanted to do. I had enough so I didn't really have to work, but I didn't have enough so I could do any damn thing I pleased.

A guy called me offering me 300 shares of Bell Rich Oil and I had the cash and I said, "Sure, I'll take the listing."

It was selling there maybe a fifth of what the oil companies were. They owned the oil field. So I bought it. Then he called me back and said, "I've got 1,500 more." I didn't have the money on hand. I had to sell something. I think about it and I said, "Hold it for 10 minutes and I'll call you back." I thought about it for 10 minutes and called him back and didn't buy it. Well, Bell Rich Oil sold about for 35 times the price I was going to pay within a year and a half.

If I had made the different decision, the Mungers would be ahead by way of more than a billion dollars, as I sit here now. To count the opportunity cost, it was a real bonehead decision. There was no risk. I could have borrowed. There wasn't the slightest in borrowing money to buy Bell Rich Oil. The worst that would happen was I would get out with a small profit. It was a really dumb decision.

You don't get that many great opportunities in a lifetime. When life finally gave me one, I blew it. So I tell you that story to say you're no different from me. You're not going to get that many really good ones — don't blow your opportunities. They're not that common, the ones that are clearly recognizable with virtually no downside and big upsides.

Don't be too timid, when you really have a cinch. Go at life with a little courage. There's an old word commonly used in the south that I never hear anybody use now, except myself, and that's gumption. I would say what you need is intelligence plus gumption.

Shareholder question on BYD

Munger: BYD, Li Lu is in the back standing up. Li Lu, come up here. This is the man who got me into the BYD.

Li Lu: What do you want me to say?

Munger: Like it is. Why did you buy BYD when you did?

Li Lu: It really is a quite unusually talented group of people who were able to manage, to solve a problem like no other group of people I've ever seen. Like all other talented people, they have their ups and downs. But in the first 15 years since BYD was founded, he has 15 years uninterrupted period of time of compounding at about 75 percent annually. It's nearly doubled every year for the 15 years in a row, for the first 15 years, with very, very little capital. They originally maybe $300,000 US, and these money twice, and altogether a few hundred million by the time they reached multiple billions in revenue.

Of course, that growth was accumulated with all sorts of different problems. Some of you who follow the stock, you have seen that in the last few years. And just like they have always done, they have dealt with it just the way it is.

They have put their heads in the sand and solve the problem, one-by-one, and slowly but surely, after three years, they solved most of your problem. They're now back on their feet and strong.

And the speed of which, they really mastered the technology. It's just unprecedented. I've never seen anybody like it. For example, they got into the auto business in 2003, and produced their first car in 2005. That's only seven years ago.

Munger: And they did this with almost no capital.

Li Lu: Little capital.

Munger: And over our objection. [laughter]

Li Lu: They competed with everybody. The Chinese auto market is about as open a market as any market in the world, better than US. Every auto maker on the whole planet is really competing there. They all have much richer capital base, longer history, well recognized brand name and superior technology. Yet this little company was able to really stand on its feet, and now they're probably selling 500,000 cars a year. But more importantly, they have a mastery of the state of the art technology from the traditional auto while really pioneering all the technology know how's of the new cars and electric cars.

In a few years, all of the BYD cars are likely to be either hybrid, or platinum hybrid or electric, and also equipped with the state of the art technology from the traditional combustion engine, and also promising efficiency.

It is not a normal feat. I cannot find it in any other group in this field.

Munger: The Korean's did the same thing.

Li Lu: The Korean's did it primarily on the traditional auto, and in a term, in a way to catch up with the traditional auto, but they have not, in a sense, pioneered a new technology pointing in a new direction. They just basically matched everybody else, that surpass in a certain area, but it's no kind of making a new path. They also have a whole bunch of other driven areas that have creditable promises. That was really the reason we're all quite enthused about it.

Munger: These are very unusual people. This is the son of pheasant who got through engineering school, what with the aid of a brother, and got a PhD in engineering at a young age, and so is a very talented human being. Of course, they are hiring young talented Chinese engineers. They are hiring them by the thousands. How many employees does BYD have now?

Li Lu: About 180,000 people.

Man 4: They are young Chinese. I don't want to compete with 180,000 young Chinese. I'd rather bet with them. Anyway, you ask a question, I think? You'll have it direct from the horse's mouth.

Shareholder Question: I was wondering when the electric car might make it to the United States. Can you expand on that?

Li Lu: Well, they have basically, I think correctly, chosen to focus, and going to treat the car effort into public transportation. Transportation rather than probably the largest contribution across the emission of pollution, and also they really would utilize the data on the battery, because they are on the road all the time. As far as I can tell, their battery probably has the longest hours on the road as we are speaking. There are probably tens of millions of hours accumulated on the road. Therefore the longer they run, if their batteries are good enough to run for a long time and of course after 30 million miles on the road, they have proved that point.

The longer you ride, the better and superior economics of the electric car has really become. At least in China, the differences of the electricity and the gasoline is about 80 percent off. That actually is here too, and in Europe, the economics are even more superior because of the surplus taxes on gasoline.

Who is the 80 percent of the savings operation? The longer you're on the road, the more savings you have. In fact, if you use for public transportation, for taxis or electric buses, just the saving itself within the several years could've produced multiple cars, given the expectancy of the battery life.

At least the company believes that the battery would last longer than the car itself. If that were the case, they would be able to make multiple...the savings itself would pay for multiple cars within the life. So much so that the Chinese Development Bank recently have committed about 30 billion Chinese dollars in loan to finance a package that people can really pay to zero down. No down payment, to purchase cars and use only the equivalents of gas free cost to pay for the entire mortgage.

They calculate, in the end, they will still make a profit, a large profit. If that becomes successful, it would really lay out a new business model for electrifying public transportation.

Given the air quality of Beijing and all the other cities in China, China has 7 of the 10 worst polluted cities on the whole planet. Public transportation contributes roughly a third of the emission. Electrifying the public transportation with BYD has proved A) doable, B) profitable, and C) actually good and providing enormous social benefit.

This is a line they're correctly pushing in that direction, not only in the US, but not only in China, but all over Europe and all over South and North America. They have several dozen trials going on all over the major capitals of the world, as we're speaking.

Munger: Yes, but tell them about Beijing, because this is very interesting. Beijing probably has the worst air pollution in the world. People are dying from pollution. Of course, it's a huge metropolitan area. And the net purchases of BYD electric taxis and buses in Beijing is zero.

But we like that, because that leaves a lot to be done. Of course, what happens is the Chinese local governments have enormous autonomy. They favor the people that are providing jobs in Beijing, making standard automobiles.

Yet if more and more people are dying, is that going to last forever?

Our bet would be that one way or another, China will get a lot more electric transportation and public vehicles in its heavily polluted cities. BYD is better at that than other people, and they may have quite the market. There are quite a few Chinese in some big polluted city.

It's a lot like the Daily Journal. It's an upside that you're really not paying for. We bought those little public notice rags, we got an upside that we weren't paying for. That's what we're doing. But that's more than you probably anticipated when you asked the question of BYD, and you had the man in America, who probably knows more about BYD than anybody else, to tell you what you want to know.

(missed a chunk here...)

That reminds me very much of a man I knew when I first came to California. The name was B. B. Robinson. In the pool operations of the late 1920s, he was a very young man. He scrambled out of the ruin of the great crash with about $10 or $11 million in cash and came out to California, where he spent his life doing heavy drinking and chasing young movie stars. Those days the banks were quite serious about the kind of clients they had. The leading banker took him out to lunch and said, “We're terribly concerned about all this drinking and chasing movie stars and so forth.” B. B. Robinson looked this banker in the eye and he said, “If I were you, I wouldn't worry.” He said, “My municipal bonds don't drink.”

In the sense the Daily Journal is like B. B. Robinson, we may have had a little flurry here of venture capital type investment, but we might actually succeed at it, and if we don't, we still have a lot of municipal bonds that don't drink.

We have assets that if this fails, we're not alone in the world without resources. Yes?

Shareholder: Charlie, you mention this idea of gumption -- also have the courage to take advantage of things. Can you help us understand just a little bit more about how you balance those two, because from that example -- obviously, it would to be aggressive, but there's also the sense that Berkshire's always been much more prudent and cautious than others.

Munger: Well, yes. That's an interesting example. Berkshire, of course, if we behaved like Rupert Murdoch or somebody — that is, we used all the credit we could get all the way — Berkshire would now own the world.

We have achieved what we've achieved with our hands tied behind our back. The reason for that is, of course, is that we have a fiduciary gene. We know the human faces. We trusted Warren when he was young and trusted me when I was young and so forth. In many cases, it's their main asset in life. We're just not interested in taking a substantial chance of taking a lot of very decent people back to "Go" so we can have one more zero on our net worth at the time, and they put us under the ground where we can't come back anyway.

We're just not going to do it. We are not maximizes in the world of capital -- aggrandizement through aggression. But what I did had no risk.

There are real risks. We didn't know the whole damn world was doomed -- implode in something really serious in the last crisis. Berkshire was not buying hand over fist with its available resources. It was making sure that Berkshire remained through it no matter how awful the conditions got.

Berkshire is a conservative way to face the world. If you want real aggression, why it doesn't play its hand with that much aggression. It does in cinches. But if there's real risk, even though the odds are in our favor, we're not going to play too hard. And that's just the way it is.

What I'm telling you is when it's virtually a cinch, or it's in a gamble you can easily afford, and the odds are way in your favor and you know it for sure -- I'm just saying don't be timid. Gurin never needed that advice. He was never timid.

Shareholder: When Bell Rich Oil goes up 35 times, it's pretty...I imagine myself have a lot of regret or debilitating. How does one recuperate from something like that? A big missed opportunity?

Munger: Yeah.

Shareholder: How does one recover from that? How do you end up not dwelling on that?

Munger: You know what Kipling said? Treat those two imposters just the same -- success and failure. Of course, there's going to be some failure in making the correct decisions. Nobody bets a thousand. I think it's important to review your past stupidities so you are less likely to repeat them, but I'm not gnashing my teeth over it or suffering or enduring it. I regard it as perfectly normal to fail and make bad decisions**. I think the tragedy in life is to be so timid that you don't play hard enough so you have some reverses.**

Shareholder: You commented on the challenges that the newspaper industry and other forms of print media. Can you comment on Berkshire's investments in the newspaper industry as of late?

Munger: Well, sure. I'm glad to. The papers that have the best hands economically are the ones that have a real community acceptance, that are part of the warp and woof of the community, like in the small towns. Those are going down slower and are proving to be better investments than the big city dailies, with the expensive difficulty of carrying great heavy stuff through big cities and so on and so on.

That's by and large what Berkshire is buying — the entrenched, small, local papers. We're trying to buy them, and we don't mind something that is declining. After all, everybody that buys an oil field is buying something he expects to decline in due course to zero. They just expect to make enough money out of it to compensate for the money they're employing.

That's the way we feel about most small newspapers. We think we're very likely to get our money back with a modest rate of return at the worst. And the stuff we're buying. The reason it's available is other people just — the idea of a lousy investment. Doesn't appeal to them. But — we like newspapers.

Who can tell? They have such a wonderful history and make such a wonderful contribution to civilization. I think if you buy them on the basis where you're very unlikely to get hurt very much. We've got a system for managing a lot of very high-grade people, namely the world of people. Let us note. The people were buying you're perfectly decent people who stay on, so we're glad to buy newspapers.

But it's not that newspapers have some fabulous growth, high growth future. Of course, they're an object lesson of the hazards of leverage if you get a big technical development that goes against you. When this alternative technology came in, it just destroyed capital values like you can't believe.

Even the New York Times -- for which you'll soon be paying four dollars or five dollars at an airport if you're not already -- has a pretty modest prospect. I think it will continue to make pretty good money as far ahead as you can see, but I don't it's going to gallop to the heavens or anything like that. There are very few New York Times, just in terms of that a niche, where people won't four dollars or five dollars for it in an airport.

I think newspapers as economic entities have way worse prospects than they used to. Believe me, Berkshire's not buying these things expecting some bonanza. I don't think

there's any foreclosure boom to create a sudden ton of lovely money for all of Berkshire's newspapers. It's a decent investment and it's responsible behavior. We have tons of money. It's just costing us zero to borrow. I don't think there's anything useful to you in our newspaper purchases.

Shareholder: Yeah. Two quick questions about the investment portfolio of Daily Journal. Who's going to manage your investment portfolio when you're not managing it? And the second question is how come you've chosen not to tell us what's in the investment portfolio?

Munger: Well, look. You can figure it out anyway, but we have a general attitude that, we will tell people what we hold and why we do it, because we don't want to buy more. We don't want to sell. We don't want to be talking about our investments any more than we have to. Berkshire does the same thing. You shouldn't be surprised.

End of the day, it is not...If I thought that portfolio needed a lot of management, we wouldn't be having it. Like B. B. Robinson's mom said, “Don't drink.” That portfolio's like to do well when all of us are dead.

Shareholder: In spite of your comment about not knowing who competes with BYD employees, can you share or do you have to respect the manufacturing ...

Munger: Manufacturing what?

Shareholder: Just the manufacturing industry in this country.

Munger: Well, of course, manufacturing has gotten way more competition than it used to have -- a lot of it from China. It's been devastating. One of Berkshire's greatest mistakes was when we gave two percent of Berkshire for a wonderful shoe business in Maine, which was the wonderful, most trusted supplier of J. C. Penney and so on and so on. Basically I would say we gave two percent of Berkshire. What we got was hardly anything.

It was a big mistake. On the other hand, it just impaired Berkshire's performance by two percent once in one year out of many, so while we remember the mistake we made in the hope of not repeating it. In the hope of not repeating it, it wasn't that they could deal in terms of the outcome, even though it was a true opportunity cost loss was enormous.

Berkshire got clobbered on a Chinese competition in shoes. Chinese had armies of young people engaged in subsistence agriculture. They were disciplined, organized young people. Sort of a Confucian family ethic and so on. They're not a crazy bunch of hippies. They came into these factories and they learned rapidly how to do a lot of complicated stuff.

The Chinese are very entrepreneurial. For years, they were called the Jews of the Orient. That was a compliment to both people. You take these people who've been hobbled by crazy rulers and a Malthusian trap where they had to just keep working like a goat just to

stay alive in terms of calories. And unleash them on modern capitalism. You've got a very powerful force.

Of course, that's an interesting force. It's not easy to make a lot of money in China, just because you have that one insight. After all, all kinds of crazy things can happen. China has its fair share of corruption. It takes talent to do well, but there are powerful forces there that were operating, and that are operating.

I don't think, BYD, anyplace else in the world could have done what it did. To go from no capital and no knowledge, except basic engineering, not related to automobiles. To go from no cars to 600,000 cars a year, I don't they could have done it any place on earth except China. For the right kind of an operator, China creates some remarkable opportunities. But of course, there are never enough of what I call the right kind of an operator.

I don't think Wang Chuanfu hardly ever has worked a week that doesn't have 70 hours of labor in it in his whole life. These are not normal people that make these unusual achievements.

American manufacture. Well, American manufacturing, of course, doesn't sound like Wang Chuanfu, does it?

Not that it isn't good and doesn't have some talent. It hasn't had such hardship. It's a more affluent culture. It's not the same. I do think there's a lot of talent in American manufacturers. I looked at some of these companies; take the Otis Elevator company. They are good at the elevator business. The elevators work. They're serviced and that would be a hard business for somebody to nudge them out of. There's some great imagination in American manufacturers. I don't think we've lost all of our manufacturing business. Even Boeing, which has made some really stupid mistakes will recover and do well.

You're doing something that's difficult. It's creating new airliners from scratch. It's easy to have the first in, but I don't think Boeing is dead as a major manufacturer. They'll solve all their problems.

If you stop to think about it, Boeing has presided in America over a culture that has created whole years, whole series of years, without a single fatality for a passenger on a commercial airliner. That's a huge technical achievement. The achievement part of Boeing hasn't gone away, because they got one big glitch (speaking, I believe, of the recent battery problem).

There's been a lot of renewals in American manufacturing. You've even had some that come back from abroad. It's a great civilization and it has a lot of achievement still in it. But I don't think we'll be making many shoes in America.

Shareholder: I'm just wondering what your thoughts might be on California politics and the propositions and maybe the marginal tax rates that we face here.

Munger: Well, I think California's policies have been insane. For a state in the United States not to be user friendly to the elderly rich is a massively stupid thing to do. It's a mistake that's not made by Hawaii. It's not made by Georgia. It's not made by Florida. It's not made by lots of other places. They want to be very user friendly to the elderly rich. Elderly well to do aren't committing any crimes. They don't fill your prisons. They have terrible health, for which the United States government pays. So, you have wonderful employment opportunities for people. They've got money that comes in for sure, which they have to spend. They don't burden the schools, which are very expensive to run.

You're out of your mind to drive out the elderly well to do and California just keeps thinking that the ideal way for the taxes to drive out the elderly rich. This is insane. I live amid the elderly rich, as you can well imagine. I want to tell you that a lot of them are self-centered and lot of them will leave. They've got options. Other elderly rich won't come. A lot of people won't come to open manufacturing plants.

California has insane tax policies in a world where other people are smart. You take this room. How many people realize California operated more like Florida in terms of being friendly? I don't like young people committing a lot of crimes. I don't like huge costs. By and large, I like the elder generation. They behave pretty well so far. I don't want to force out the elderly rich.

I think our policies are stark raving mad. This idea of constantly having people game the system to get money without effort, which happens in workman's compensation insurance and lots of other places, just massive fraud. I believe all that stuff should have been squeezed out and un-encouraged. But the people making money out of the system have huge political power. So, a lot is wrong in California.

On the other hand, a lot is right. I wouldn't move across the street to save my children $50 million. They're entitled to what's left over, so I'm not going to be chased out by California taxes.

I recommend that same course of action to all of you. Let the little darlings have what's left over. But **I don't think we should torture our whole life to make our children's life as easy as we can possibly make it**. This room, the main difficulty's going to be we make the children's lives too easy, not that we make it too hard.?

Shareholder: Charlie, in the past the board has offered some book recommendations. I wonder if they might have books that they might recommend. And yourself?

Munger: Well, I'm reading a physics book that I recommend to everybody. It's called "Something Out of Nothing," which is a...It's one of the most remarkable books I've ever read, and something we all ought to know and practically know. But it's basically...The recent history and outcome in astronomy and astrophysics, and it's utterly fascinating, at least to me. I think some of you will find it interesting. It is the most remarkable story, and it's all happened while we were just sitting around securities.

When I was young, they didn't know why the sun shone. It was Hans Bethe who figured that out. When he did, he figured it out one afternoon. He took his wife out to dinner, and

he said, "You're having dinner with the only guy in the world who knows why the sun shines!"

But there have been dozens of those achievements. “Something Out of Nothing.” It's absolutely fascinating. Of course, what's happened is fascinating, of how something -- how could you have a Big Bang and a whole damn universe appear? I guarantee ya some won't like this book;

…

Munger: Well, we ordinarily let these things go on way too long, even though we have a board meeting, because some of you have come a long way, and we'll do that some, but it won't be endless.

Shareholder: Lawrence Krauss (author of the book)

Charlie: Lawrence Krauss, yeah.

Shareholder: I have a question about the government involvement in the economy. It's obvious that with continuation of QE that government's doing a lot to support the economy and the market and the stock market. What do you think the right role … and involvement, and what do you ?

Munger: Well, you just asked one of the most complicated and interesting questions and one of the most important questions in the whole world. Of course, nobody knows the answer -- just when too much is too much. We know you can't just start printing money to run the whole economy and stopping taxation. At some point on that road, you get a backlash, which causes anguish you don't want to get to. But how far you can go in having these Keynesian benefits and get by with it without risking that backlash, nobody knows for sure. **If you're like me, I believe in giving big trouble a wide berth, so I would try and stop a little short on this. Solving my problems by printing money.**

Somebody like Paul Krugman, who's overdosed on mathematics, and uses the king's English better than practically anybody alive, so he's very dangerous. He just thinks there's no limit to the amount of -- he wouldn't say that, but he thinks the limit is so far away you don't need to worry about it at all. That is not my view. But nobody knows the answer to that.

Shareholder: I wanted to see how you see the retail landscape. The future of retail from your Costco lens, and how it might be affected...?

Munger: Well, that's a very good question. I think retailing is going to get tougher and tougher and tougher. I don't think Costco is making it easier on others. I think Costco is one of the winners. I'll give you an example. I just got a new tube of toothpaste. I didn't buy it. The man who helps me with the house -- a very nice man -- bought it for me at Costco. I've used the major brands of toothpaste all my life. The brand on this toothpaste is Kirkland.

Costco got one of the major toothpaste manufacturers of the world to make their toothpaste in Costco's tube at a very low price.

This is not good for the Proctors and Gambles and Unilevers of the world, and the Colgates of the world. So, generally speaking, that's one threat.

Then you add the Amazon threat.

Then you add the fact that we have too damn many stores that are the natural over-optimism of both lenders and real estate developers and merchants and so forth.

So, I would say retailing looks tough and dangerous to me. Now, that isn't to say there aren't some people in it that are so good they're going to succeed in spite of everything, like Costco, but I think for ordinary people engaged in retailing, it's a business that's going to have a lot of head winds.

That Amazon system, where you just punch a button and it comes the next day. Don't have to drive through traffic; you don’t have to look for a parking spot. You don't have to wait in line.

It's pretty damn simple, so if you got something expensive. I think the Amazon thing is a big cloud, and I think the rise of the Costcos and the Sam's Clubs and so forth, so the Proctor and Gambles of the world keep losing . I think retailing is tough. Don't you? That's why you asked the question.

Shareholder: I think it's really tough, and it's ...

Munger: Yeah.

Shareholder: I'm almost running out of...

Munger: He wanted to hear somebody else say what he already believes. He should go to the Catholic Church.

Shareholder: You described what seemed to me is an unsustainable situation.

Munger: We know there's some limit, don't we? Everybody in the room knows it. Keep pushing that forward and it will eventually blow up in your face.

Shareholder: Most of us admire is how resolute you've been with your investment philosophy. Can you talk a little bit on that?

Munger: I don't think I've changed my views on any of those subjects in a long, long time. It isn't like the first time I've seen collapses, opportunities, craziness, disappointment.

No, I think one of the reasons -- we in our old catechism -- use your head. Of course, we have nothing but contempt for modern portfolio theory and all of this stuff they teach in business schools. One of the blessings that I have. I never went near those crazy people.

By the way, I'd be glad to have any one of them marry into my family. **They're nice people. They just have the wrong ideas.**

By the way, all their ideas aren't wrong. It's just the ones that are related to portfolio management are wrong.

Being a professional money manager is not so easy. It shouldn't be easy. You're complaining about not having egg in your face; you say you had. Furrow your brow a little bit, and your plan worked.

Shareholder: Hey, Charlie. That gentleman back there on the book recommendation.

Munger: Yeah.

Shareholder: I have a book recommendation, but the story -- it has both humor and mystery attached to it. In effect, you're going to get a Warren Buffet book recommendation here. I've got this email the other day from Todd Combs. He said, "Warren gave me a copy of this book yesterday, and I just finished it. And would recommend you read it as well." The name of the book is The Outsiders. I had a member of my staff buy that. I'll get to that. Give me a moment.

I had a member of my staff buy the book from Amazon, and the book arrived. Rather -- how unusual a book for Warren Buffet to recommend, but I thought maybe he's getting more like Charlie. Charlie is always reading very interesting, unconventional non-business books.

Well, this is really an unconventional book. This is about a group of lower class students who are being bullied by very high-class rich students. I thought, Wow! Warren Buffet's really branching out in his reading. But two days later in the mail, I got a book from the author, Mr. Thorndike. A book called The Outsiders. It's a book about Henry Singleton and Warren Buffett.

All these different business people who operate outside the normal conventional approaches to business. So the mystery was solved. I emailed back the author of the book and I said, "There may be other people who are going to make the same mistake I did. Maybe you should get with your publisher and figure out how to make sure Amazon makes it clear to people looking for The Outsiders that they don't get confused; By the way, would anybody like this?

Munger: That book by Thorndike is quite an interesting book, because he describes companies and their CEOs who had utterly remarkable records and there's some common threads.

They were a very unusual bunch of people, many of whom I knew personally.

These were not normal people. They were Henry Singleton and Tom Murphy and so on. That is a very good book for you investment types. It's really very, very interesting. I think that there's one category that's not -- no, it's too much, but most people. **The ideal investment in many respects is one where anybody who owned it could make a lot**

more money with no risk simply by raising prices. You say that there can't be such opportunities lying around anymore than there'd be lots of $100 bills lying around unpicked up on the streets. How could there be?

But if you read that book, you'll realize that in the early days of network television, it was a cinch. All they had to do was sit there and keep raising the prices. Then you make huge amounts of money.

But the main thing was you were sitting in a place where all you had to do was sit there with your network television station, keep raising the prices. And there are such opportunities, and you may find a few of them in your lifetime. If you can identify them, it's some of the easiest money that there is.

That happened to us with See's Candy. When we bought See's Candy, we knew it was a marvelous business -- well run and made a nice candy, but we had no idea it was selling at $1.95 a pound. And we had no idea that we could just keep raising the prices, year after year after year by large amounts. And the earnings would keep going up or staying the same.

And See's Candy grew -- many years it's yielded more than 300 percent per annum than what we paid for the whole company. Partly, people just don't care if it goes up an extra 25 cents a pound, because it's a gift item and they love the candy. There's no price reference. Warren and I did not realize that pricing power existed. We found out by having a little gumption and doing.

There again, other factors made the company worth what we paid for it, and this extra opportunity we didn't pay for. It was these little public notice rags that Jerry bought. There was a possibility of having a bonanza if certain things happen. And a given fact that thing had no price resistance to speak of. We could have a bonanza and lo and behold, we did.

And of course, I would argue that we wouldn't have bought Coca Cola as early as we did if we hadn't had the experience with See's Candy. We just learn through doing how powerful some brands were. And so, I recommend to you people the same idea.

It probably took some gumption to buy See's Candy. We didn't know anything about the candy; we didn't have anybody that knew how to run it for sure. But the gumption to think of the bonanza that's been brought.

OK, We are going to have a director's meeting. I have done my duty for you groupies.

I'm Charlie Munger, Chairman of the Board of the Daily Journal Corporation (DJCO), and I welcome all of you, including the groupies....Our [new] independent accounting firm is here. We prefer you to our old one. You remind me of my own personal circumstances. They once asked me what one person accounted for most of my personal felicity in life, and I said, "That's easy – that would be my wife's first husband." You have an ideal position of the same sort.

I'm going to talk briefly on accounting and then I'm not going to talk any more on the subject.

To be as late in publishing an audit as the Daily Journal is absolutely unheard of. It's unbelievable. Had the mafia been running the company with the worst excesses in the world you wouldn't expect an audit to be this late. It set a new record in the history of the world. We obviously had an audit from hell, and the question is, what caused it? Our auditor would say it was our sloppiness in internal controls. God knows, we've had a few imperfections, but in my judgment they were trivial and of no practical consequence to anybody with any sense. The auditors would say that our difficulties were really serious. They were confused by the difficulties of our business, which God knows are confusing and difficult, but that's external reality. They were like the doctor who wants to fix a nose bleed by

feeling around in the groin, and charge for it by the hour.

It wasn't malevolent. They're a big bureaucracy and they did us enormous damage, the way an elephant would do damage if it went through a barnyard and stomped the chickens. It just comes with modern life, but [DJCO Board Member] Peter Kaufman always says that no occasion, no matter how terrible, is totally un-useful. It can always serve as a useful bad example. That's the way I feel about this audit.

We are a service operation ourselves. We're a bureaucracy, and we have plenty of power in this complicated software business of disappointing some customer who trusts us. We're using our audit as an example of the kind of thing we never want to do to anybody else ourselves: just unwittingly do something stupid that does a lot of damage.

Now of course our main competitor in this software struggle just loves our being in the headlines for not getting audits out on time. Just think of how a commissioned sales force reacts to that. The auditor was feeding our main competitor lots of red meat and billing us for it. It was not the happiest occasion in the history of auditing.

I don't think it hurt us at all in the financial community. Any ordinary company would have been crucified, but we have a reservoir of trust and reputation, so I think it was a non-event to people like you. I do think it hurt us with the customers. Whether our auditors hurt us five million dollars (counting opportunity costs) or some larger sum I cannot tell you, but it was a significant unpleasantness, and it was – in my judgment – totally unnecessary. But there is no feeling on our part that our auditor was any worse than any other member of the Big Four. I think when we have big bureaucracies and new responsibilities under the law you get some odd occasions. Our business situation being a venture capital-type situation would have confused practically anybody who was restricted to auditing experience. It was sort of a natural human craziness and it's not unexpected.

The right way to react to it I think is clear. Turning the other cheek didn't

start with Jesus at all. The real guy who figured that out was Aristotle. He just thought it was crazy to spend your time trying to get even based on some injury. You just suck up your gut. We paid all the invoices with the extra payments so they could hurt us more. We're not going to do any more. Our new auditor at least is local and we're a bigger client to it than we were to the old one. Part of our trouble was that our business situation was complicated and I'm sure we didn't draw the top talent to our tiny little business.

I also think that when something bad happens it's always partly your own fault. With 20/20 hindsight both Gerry [Salzman, DJCO CEO] and I have a fault, and I have it way worse than Gerry, and that is we get along beautifully with people we trust and admire – it really causes something more like love, which I like in business and in life – but the people we don't admire, neither of us is very good at disguising it. I think that this went from bad to worse, and I don't know how to fix people as old as Gerry, and of course I'm old, so we just have to soldier on as best we can.

Hopefully, the new auditors will be more admirable. It's hard to imagine that they could be worse. They have one of the easiest jobs in the whole world in satisfying a client. We're treating it like Aristotle. It may have cost the company quite a bit of money, counting its competitive effects. They did not do it on purpose. They did it utterly unwittingly, without the faintest idea that maybe if they delayed our audit report month after month after month it would hurt us in the market with a big competitor with a bunch of commissioned salesmen around spreading the happy news that the Daily Journal's internal controls were non-existent and they were no good and so on. That's all I'm going to say about auditing.

Daily Journal: the Business

As we have said over and over again, we have a declining business. The business of running a newspaper with information content delivered by printing presses, even when it's a legal newspaper, is declining. The golden revenues were from publishing foreclosures notices. We made a lot of money for a while. It was sort of like being an undertaker during the

Black Death. For two or three years it was a wonderful business and the population of Europe declined by 40 percent. That's what we went through.

We kept the money. I would say that we handled our situation very well, and we still have a 90% share of the public notices in foreclosures, but there practically aren't any right now. The banks, the lenders, have all tightened their standards and the real estate prices are back up, so of course the foreclosures are pretty close to zero. We have a declining business in its very nature.

If you take the whole history of businesses that make a fair amount of money and have a little surplus but their basic business goes to hell based on technological developments, the results are lousy. The normal result is Kodak (ticker: KODK). Imagine having a business like Kodak and having it go all the way to bankruptcy. That's the normal occurrence: technological obsolescence.

There are few exceptions in the history of the world. One of them is Thompson Reuters (ticker: TRI). They were a newspaper company with a few television stations added and they basically milked them as long as they could, sold them for high prices, and went into a different business – online information – and they successfully made the transition. That is really rare.

The other rare example, of course, is Berkshire Hathaway. Berkshire started with three failing companies: a textile business in New England that was totally doomed because textiles are congealed electricity and the power rates were way higher in New England than they were down in TVA country in Georgia. A totally doomed, certain-to-fail business. We had one of four department stores in Baltimore [Hochschild Kohn], absolutely certain to go broke, and of course it did in due course, and a trading stamp company [Blue Chip Stamps] absolutely certain to do nothing which it eventually did. Out of those three failing businesses came Berkshire Hathaway. That's the most successful failing business transaction in the history of the world. We didn't have one failing business – we had three.

Out of that little nothing, the excess capital that we took out and put somewhere else did better than anybody's ever done. As a matter of fact, we recently passed General Electric [ticker: GE] in terms of market capitalization, and GE was founded by Thomas Edison himself in 1892, and one of the most powerful companies in the world.

It was a considerable stunt. But the normal result is more like Kodak. Xerox [ticker: XRX] is an interesting case. They went to the brink of extinction and then came back, but they are a pale shadow of their former greatness. They actually invented most of the stuff other people made so much money out of, and they still failed. Bill Gates is a big student of this subject, and he says that the standard result is failure. Imagine General Motors [ticker: GM] who went bankrupt. Can you imagine how they towered over the economy when I was young? It was the biggest, more valuable, most admired company, and it took the shareholders to zero.

What Daily Journal is left with is a declining business. It may last quite a while, but at really modest profits. The future is our software business and we really like that. We think all these courts should be automated, and it should be a configurable system and it should be in the cloud and these public agencies should be serviced lovingly and honorably and loyally, and that's exactly what we plan doing. New Dawn Technologies, which so worried our auditors, I asked them a question today before we came in here: of your existing clients, how many are threatening to leave? They have about four hundred clients and they named one. As far as I'm concerned, I like the way that's worked out, as a venture capital type of investment. I like the people and I like the ethos and I like what we're trying to do. It's a great big market.

Most big software companies hate dealing with the government. IBM [ticker: IBM] got very good at it, but everybody else just hates it. You have a business like Microsoft [ticker: MSFT] and you don't need a bunch of RFPs [Request For Proposals] – it's just agony. We actually kinda like the agony. The people really need better products. Who knows, we may actually pull it off, but the objective evidence would be that we're trying to do something that very few people have ever succeeded at: take a

successful business, clobbered by a change in competition, and have it out of the ashes raise something that's pretty damn good. That's what we're trying to do.

I think the odds are better than even that we pull it off creditably. I don't think it will be a super-bonanza, but our standards of creditable are pretty satisfactory. As to the surplus money, thank God we have it. Most of the newspaper businesses – about half of them went broke or nearly broke and they borrowed so much to buy other newspapers because that's all they know how to do, with the aid of so many friendly investment bankers and consultants, that they basically took their own shareholders to zero after having long years of monopoly. That has not been the result here. We have all this extra money on the balance sheet and we're using it to create a software business.

I think you all would have liked the board meeting we had before we came in here. The people strike me as honorable, intelligent and cheerful about the difficulties of this very difficult business, which are a whole lot of bureaucracies, governmental in nature, with a whole lot of different consultants influencing the customer. It's not a bit easy, with very difficult questions of what you do and why you should do it, whether the new system is going to work, and if so, why? I actually kind of like it even though I don't understand it. I have the feeling that we're not going to get a lot of new entrants into this business. Our main competitor is in a formidable place, but if I were buying the product, I'd buy ours and not theirs, and that's my test of proper competition.

With those remarks, I'll take questions….

Q: What's one thing that you are excited about in the next year, professionally and personally?

Munger: That's spoken like a true groupie. Basically, I lead a very favored life. I've got wonderful associates. I've had problems that my abilities were able to solve. Working on a problem and lacking the ability to solve it is unpleasant. Luckily, I have selected very easy problems all my life, and I have a reasonable batting average.

I feel very thankful that I'm alive and that I've been so favored. It's very easy to get discouraged by what's wrong and forget what's right. There are a whole lot of developments that I really don't like.

I don't like the vast growth of legalized gambling, including the legalized gambling run by Wall Street in the form of derivatives trading and so on. It's bad for the country.

I think one legal drug is enough. I don't think society is going to be better with two or three or four legal drugs. If I look back in my own life, 95% of the people have handled liquor responsibly. It may even have been a slight plus in their lives. The other 5% have created enough misery to counterbalance all the felicity of the others. As I look back, at least one person in twenty has ended in total alcoholism and half of them died young and half of them recovered. It was a lot of damage.

I also don't like the increasing tendency of governments to pay off fraud. If I were running the world I wouldn't pay off anything that could be easily faked. It's so bad for people to learn to lie to get money from the government — just to have everybody hire somebody on a contingent fee to say his back hurts or his life adjustment is bad because of a psychiatric difficulty. I find this appalling. What kind of nut cases running our government would create a fraud like this? It's crazy – you're teaching people to be crooks, you're paying people to be crooks.

On the other hand, if you look back over 100 years, it's just fabulous what's been solved and how much better off the average person is. I was

recently at Harvard for a little bash, and Harvard really thinks they're about to create pancreatic cells from stem cells. Considering the prevalence of diabetes, that would be a considerable stunt. Some of that stuff is coming. Just take the quality of the cars we all drive. Think of what clever engineering it is, how much the safety has been improved, etc. A lot is done right.

I have this grandson who is at UCSB in computer science. I've had a whole bunch of the science and engineering students around my dinner table over the years. It makes you feel good about your country. Now, there are a lot of the people at the bottom of the pit around UCSB living in Isla Vista, but they weren't invited. Basically, if you want to have an orgy, I want you to have it somewhere else.

On balance, I'm not as optimistic as Warren [Buffett]. I don't see how anybody could be more optimistic that Warren. He has this real faith in the long term. I'm not quite so enthusiastic, but he's right that there's a lot good that's happening.

If you take what China has done from what China was, there's been no achievement on this scale in the entire history of the world. They've done a lot of things right at which we have failed, and we shouldn't be looking down our noses at them. Imagine taking an economy from subsistence agriculture to what they have done at these enormous rates of growth, and doing it not by borrowing from the rich world – which is what we did in the United States – they did it by saving the money. They were poor, and they were saving 45% of their income. They financed themselves and they're lending to us. We seem to have reasonable peace with China and are getting along. That's very important. All the trade helps.

Mr. Picketty [Capital] is a little daft. Put me down has hoping the Pickettys don't marry into my family. It isn't that some of his numbers aren't correct, but he just doesn't interpret them correctly. Of course if a place as big as China gets really good at manufacturing it's going to reduce some union jobs in the rest of the world in every trade. But they have a right to succeed. The rest of us can be mature enough to adjust instead of

bitching about the fact that the world is occasionally a little tougher than we would have chosen. Of course there are going to be parts of the economy that do better or worse over a twenty- or forty-year period. It's not some malevolent outcome. It's a huge change, and in terms of world equality it's enormously improved. To sit in a very rich country with a 36-hour week and complain about the fact that all the other people are coming up just doesn't strike me as a very mature or noble way to behave.

Charlie Munger (Photo credit: Wikipedia)

Q: What is the Daily Journal (ticker: DJCO) doing about pricing and

other competitive issues?

Munger: The market is competitive and the outcome is not certain. I believe our product is better. I believe our business methods will be better. I don't think all the customers we want will be wise enough to choose us. It's struggle forever. There's no easy bonanza ahead. Anybody who thinks that our use of the surplus cash — which has caused such remarkable results — is a permanent occurrence, that this is a mini-Berkshire Hathaway starting again headed by a Chairman who is ninety years old, is living in fantasy land. We made some very shrewd investments and we did it once every forty years. I'm ninety. That shouldn't give you a lot of optimism. (laughter)

The opportunities were remarkable. They were the type that come along very rarely and they happened to coincide with a time when we were the only undertaker in a town with the plague. Two plus two gave us this chunk of money. If worse comes to worse, the shareholders are not going to go to zero like the shareholders of General Motors did. We may actually pull this thing off, but it isn't a bit easy.

In the whole history of Berkshire Hathaway (ticker: BRK-A), I can only think of one new business that we started by ourselves at headquarters, and that was the reinsurance department. Now, that is a huge business, and it's made an enormous amount of money. Berkshire Hathaway, for all its glorious achievement, started one new business. Everything else we bought. On the other hand, you don't need a whole lot of achievements; you just need a few.

That's one place where we're different from everybody else. Imagine somebody who thinks he ought to be paid big sums for telling people they ought to divide their business into 200 individual pieces. There are grown-ups who think they ought to be paid for giving that advice. It's weird. There is more dementia about finance than there is about sex. It's a hard subject to be rational about.

Q: What do you think about tax inversions and how they should be

addressed?

Munger: Take the one that we're in headlines about at Berkshire. Tim Horton's (ticker: THI) is bigger than Burger King (ticker: BKW). We merge it and the bigger company with the most income gets the headquarters, and it's Canada, which is practically part of the United States. Anyone who thinks this is a great tragedy or great injustice is stark raving mad. Berkshire's taxes go up a lot. But once the press goes off on something that's complicated they go berserk.

Generally speaking, in a world of free trade, where corporations are mobile, you pay a big penalty for trying to have a corporate tax system where your taxes are way higher than the taxes in the rest of the world. If I were running the world I would have low corporate taxes, and get at the yearning for equality some other way, like consumption taxes. I don't care if somebody makes a lot of money and holds it like a miser. Most people have a vast propensity to spend, helped by spouses and children.

If you take the places in the world where the citizens have done the best – Singapore, low tax rate, Hong Kong, low tax rate – you're fighting against reality with a lot of left-wing envy. I think envy is destructive. I try to drive it out of my own system, and I'm pretty good at it, too. I wish my fellow citizens were less consumed by it, particularly the politicians. I don't think our problems are caused by inequality, although I do think it's a mistake to let a lot of people get rich out of legalized gambling, although they call themselves money managers and derivatives traders and so on. If I were running the world, I would whittle that class down by about 90%. It would take me a week to write the laws. It would totally change the real estate market in New York.

Another thing: if the rest of the world weren't so stupid and bureaucratic, we wouldn't be rich, and you [the people in the room] wouldn't be rich either. This room is full of people whose comfort has come from the stupidity of other people. The same people, when they see the stupidity acting counter-productively, want to keep all the benefits and have the stupidity go away. You're asking too much. The truth of the matter is, if

you stay rational yourself, the stupidity of the world helps you. As long as they don't blunder into World War or something – there are limits.

Q: How do you combat envy?

Munger: Well, you just don't care if somebody else does better. It's one of the deadly sins out of which you can never have any fun. It's a total loser: bad for the country and bad for you. The Jews were right to put those things in the Old Testament: don't envy thy neighbor's donkey, his wife…they kept laying it on because they knew it was important even for a bunch of herdsmen. They were right. It's a pernicious thing. I see in professional firms, where everybody is overpaid by 150%, and some guy gets $10,000 more than somebody else in one year, and the guy who doesn't get it goes berserk. Is this rational, when you're overpaid by 150% and somebody gets 1/3 of 1% more? But it happens.

Q: Given your investments in big money center banks, what do you think of the big fines the government is extracting from them?

Munger: Two parts. Part one was their terrible, abusive behavior as mortgage lenders. It was like deliberately building a bridge they knew was going to collapse and kill people. It was morality on that scale. The people who did it thought they were perfect. As Maimodides once said, "Every man is straight in his own eyes." They did these terrible things and thought they were nobly serving capitalism and ought to be paid even more than they were. That was very, very regrettable.

I think if behavior is bad enough, as it was at [Enron's accounting firm] Arthur Anderson, even though the individual members of Arthur Anderson were very unfairly treated, I think you have to have some failure. The way it has worked out, very few individuals have been punished for ghastly behavior, and their companies have paid penalties that are very substantial. Whether that's exactly right is a very interesting question.

Mortgage lending became a dirty way to make money. You take people

that can't handle credit and try to make very high returns by abusing and encouraging their stupidity – that's not the way I want to make money in banking. You should try to make money by selling people things that are good for the customer. You'll never see Berkshire buy a gambling casino. Even though it's profitable and legal we're just not going to go there. There ought to be a big standard in corporate America of things that are perfectly legal but we don't do because they are beneath us. The standard that prevails is, "How low can we make our ethos and still not get in trouble? We don't want our competitor to be making money in some way that we are left out of." That's a huge mistake.

By the way, has it hurt Charlie Munger to have these ideas? Do I need more money gotten in some scroungy way? [DJCO Board Member] Peter Kaufman says something very smart: "If all these crooks and promoters knew how much money there was in being honest, there'd be more people who did it."

Take Berkshire. There have been eight large portfolio reinsurance transactions of over a billion dollars in the history of the world. We've done all eight of them. That's because people trust us. They think we'll do what we say thirty years ahead. There's money in being trusted. It's such a simple idea, and yet everybody rushes into every scummy activity that seems to work.

Our politicians want to solve their financial problems by bringing in legalized gambling. In Cass Lake, MN, they have an Indian Casino. When I was young there was no pawn shop in Cass Lake. Now there are five. All these people on pensions, they've got one chair and one television set, and they go in and lose 100% every month of everything they have above heating money.

Or the advertisements on television: imagine teaching ordinary people the way to get ahead in life is to trade securities actively on a daily basis. Is that an honest product? It's a legal product, but is it honorable? Would you want your son-in-law to do it? Well, maybe some of them are already doing it…it's a big crowd.

Q: What about succession planning at the Daily Journal?

Munger: When I came out to California, there was this playboy and he spent all his time drinking heavily and chasing movie stars. In 1950 he had ten million dollars that he got by being part of a crooked pool of some kind in the 1920s and everybody else when to jail and he came out here and chased all these starlets and drank all this booze. His banker called him in and said that he was very nervous about his behavior. He told his banker, “Let me tell you something: my municipal bonds don’t drink.”

The Daily Journal has a lot of assets that aren’t going away just because the people leave. We’re not stupid and we’re not taking the shareholders to zero. At the present time, people like you have bid out stock up to a price where I wouldn’t pay it myself. I don’t do anything about it. I don’t sell because it’s not my nature. I say to myself, well, if you have groupies, you’re going to get this crazy behavior. And – you might even be right. You won’t be right if the software business doesn’t work out very well. But I don’t think there are that many Daily Journal shareholders in the whole room. This is a different crowd of people. That’s all right – I like you all because you remind me of myself. Who doesn’t like his own image starring back at him? (laughter).

Question: The major banks have trillions of dollars in derivative contracts. What do you think about this – the size and the counterparty risk?

Munger: If you intelligently trade derivatives it’s like a license to steal, so you can understand why they all want to do it. Now, it’s very hard to control yourself when life is that easy, and banks have a way of getting into terrible trouble, and I think a lot of them will get carried away by excess. What’s the big plus of having everybody gamble with everybody else? Now you can say that it’s something that will always be with us because of the psychological nature of human beings, but I lived in a world with low gambling for decades when I was younger and I liked it better. I think it was better for the country. It’s like having thousands of professional poker players. What good are they doing for anybody?

If I were running a major bank I would have less blowup risk, and I would use different methods of determining risk. I would not be in the derivative business at all because I would regard it as beneath me. I like the banks when they get to be the trusted partner of business and extend credit to people who deserve credit. That's the most noble activity there ever was. I like it when the banks help somebody to buy a car or a washing machine or a truck and they give him an installment contract. Bank of America (ticker: BAC) pioneered all that stuff way early and it was a noble addition to the business activities of the world. But do I like this crazy borrowing on credit cards to finance vacations and so on? I know Germany seems to avoid it and they're doing fine. I think we slept with the devil when we encouraged this ballooning readiness to consume. It's a disease to max out every credit card. When I was young the banks didn't encourage it. Of course, they didn't make as much money, either.

We owned a bank at Berkshire for over ten years [Illinois National Bank & Trust AKA Rockford Bank]. Our bad debt losses were zero. Our returns on capital were higher than most banks. We never worried for one second, and for anyone who deserved credit, we were glad to accommodate them at fair prices. You don't have to go crazy because you are in banking, but a lot of people do.

Q: What are your thoughts on BYD [Build Your Dreams, the Chinese battery & automotive company -- ticker: BYDDY -- an investment of both Berkshire and Munger's Asian fund]?

Munger: BYD is getting widely recognized as being in some kind of a sweet spot in a world that's going to have to go to way more electric cars, buses, and taxis, particularly in China. In Beijing, where the average longevity is foreshortened by ten years by air that's so bad that children are gasping for breath, they have to stop burning gasoline. So far they just have given contracts to big employers who make ordinary automobiles. That can't last. China is recognizing that when you start killing people in large numbers you have to change behavior. BYD is the only Chinese company that has worked on electrical cars.

The evidence is that the iron phosphate solution BYD has to the lithium battery fire problem is a very safe one. It's counter-intuitive, because it's heavy. The people who tried to be light were out of their minds. Imagine Boeing [ticker: BA], to save the weight of two suitcases, going to a lithium battery that was very difficult to control. I'm not an engineer but I would have been smart enough to avoid that one. Even engineers go crazy. The customers want the last two pounds, says the sales department. But the last two pounds are the ones that finally kill you. So I think BYD is in a privileged position and I think it's likely to be intelligent in adapting to its opportunities.

Q: What do you think of the monetary expansion?

Munger: When you're as old as I am, you have seen a lot of inflation. I remember buying ice cream cones and hamburgers for a nickel. On the other hand, after inflation the country has done wonderfully. A lot of the people who were the Jeremiahs of that age basically have been proven wrong; the country could stand as much inflation as it got.

On the other hand, I'm not as optimistic as Paul Krugman, whom I always read because he's the smartest leftist I've ever read and he uses the King's English very well. If Germany had not debauched its currency in response to the reparations following World War I, I don't think we would have had Hitler. We wouldn't have had the holocaust. We would have avoided a lot. Flirting around with the debauch of the currency of an advanced civilization on which the whole world depends for its reserve currency, I think we ought to be pretty conservative and not just assume we can print all we want forever, whatever amounts our politicians think is convenient. I was way more afraid than Paul Krugman, but so far he's been proven more right than a lot of his critics.

Q. What do you think of Fannie Mae and Freddie Mac?

Munger: I have a peculiar attitude for a Republican. I think Fannie Mae and Freddie Mac, when they don't go crazy making lousy loans in response to the demands of politicians, are serving the country pretty

well, the way the system is now configured. The fact that we came into it by accident doesn't mean that it isn't a pretty good solution. Considering the crisis we had and the risks we faced, everybody behaved pretty well and the result is not awful.

Last time we loosened standards because everybody else was. The politicians hated them, and they couldn't stand that everybody else was making money on the subprime loans. This was envy and it was stupid. There is nothing wrong with keeping your head when all about you are losing theirs — Kipling was right. Why couldn't Fannie Mae say, we extend credit to people who deserve credit? Well, it's not egalitarian enough – we want to shovel money at the people who were deprived. The trouble with that is the whole system blows up. What looks like hard-headedness is really soft-headedness. The whole world is better when you don't reduce engineering standards in finance. We skipped a total disaster by a hair's breadth. Partly because both Democrats and Republican administrations, both Congress and the President, made decisions that were pretty much exactly right and did it under terms of terrible pressure. I'm a big fan of the people who took us through the crisis. I'm not a big fan of the people who caused the crisis. Some of them deserve to be in the lowest circle of Hell – not that I have any power to put them there.

Q: But what about when the government stripped away the profits of these enterprises?

Munger: They were private corporations with a little bit of government image and they were insolvent at the time. I don't think it was unjust. They had behaved terribly. If somebody asks you to do something that's bad enough, you can give up your damn job rather than do it. Fannie Mae did not have to cave. It was run by people who were cavers by nature. They were just looking for a place to sell out for personal advantage. That's what they did in life.

We want more people who say, "You're my boss, and if that's what you want to do, you'll have to get a different errand boy. I'm not going to do it." There ought to be way more of that. Elihu Root, probably the greatest

cabinet officer we ever had, said one of my favorite comments: No man is fit to hold public office who isn't perfectly willing to leave it at any time. Of course, he was the most famous lawyer in the world so he could immediately leave to success, whereas the other politicians, if they left, were nothing. The country would be better off if we had more people like Elihu Root making the decisions.

Q: What are you going to do with the technology companies at Daily Journal? Is there some thought to integrate the three brands?

Munger: We're going to integrate them as fast as reasonably practical. We've already started. Exactly what the timetable will be I can't tell you. One of them, ISD, was a very low risk transaction because they had contracts in place that would give us back most of our money. The other [New Dawn Technologies] was a real gamble: we basically paid $15MM-$16MM for a company with a net worth of about zero. We did that on a venture capital basis. I feel better about it now than when we did it. I've had an uneasy moment or two between then and now but now I really like the way it's working out. I like the people, I like the ethos, I like the people who are gone (I mean I like them being gone), and I'm glad we did it. I think I know more about it than our accountants do.

Q. How much investment risk did you take personally once you had made enough money to live well?

Munger: Most of the Munger money – I don't count the Daily Journal, it's just a little asterisk (laughter) — is in Berkshire Hathaway, Costco (ticker: COST), and an Asian fund. Now, you could go to the rest of finance, they think they know how to handle money, and they'd say it's totally unthinkable, Munger doesn't know what the hell he's doing. Doesn't fit our models. But I'm right and they're wrong.

If you're shrewd enough to choose well, three holdings – any one of which would support your family in perpetuity — is enough security. What difference does it make if somebody else in some year goes up 10% and you go down 5%, when you've got 1000 times more than you need

anyway? The people who make these crazy decisions don't actually have envy: what they have is clients who will fire them if they don't get the same results as everybody else. That is a crazy system. Everybody gets on the same merry-go-round. I never had any interest. As I sit here, all my securities are making new highs every day. Am I doing it wrong?

Q: Would Daily Journal consider selling itself to a competitor if the offer was right, or is it going to remain an independent company?

Munger: Generally speaking, we like selling to people we like and admire. Not everybody would fit that category. We're trying to run it so that any intelligent person would want to buy it. My attitude in running the Daily Journal, with its technology thing, is that Google would be out of its mind not to buy it. It's going to take years for them to figure that out, though.

Q: Last year you talked about Belridge Oil and how you made a mistake not buying more when you had the chance. Can you talk about your investment process?

Munger: In those days, Belridge was a pink-sheet company. It was very valuable. It had a huge oil field, it wasn't even leased, they owned everything, they owned the land, they owned the oil field, everything. It had liquidating value way higher than the per share price — maybe three times. It was just an incredible oil field that was going to last a long time, and it had very interesting secondary and tertiary recovery possibilities and they owned the whole field to do whatever they wanted with it. That's rare, too.

Why in the hell did I turn down the second block of shares I was offered? Chalk it up to my head up a place where it shouldn't be. So, that's why I made that decision. It was crazy. So if any of you made any dumb decisions, you should feel very comfortable. You can survive a few. It was a mistake of omission, not comission, but it probably cost me $300 – $400 million. I just tell you that story to make you feel good about whatever investment mischances you've had in your own life. I never found a way of avoiding them all.

Q: Given your accumulated wisdom, what do you know today that you wish you knew when you were first started investing in stocks?

Munger: Like Warren [Buffett], when I was young I scrambled around doing anything that would work, and I could get a tiny little obscure company that was too cheap because they were on the pink-sheets, and all kinds of things. As I got more money, I decided I didn't like all that scratching around. I was thinking about things I didn't want to think about. I wanted to admire the people who were running the business. I wanted to admire the business, think it well-placed, and going to do well. So, I drifted into this, good people, good company field in my old age, and I found it much more comfortable, and my returns haven't gone down that much. It's remarkable.

Q: What would you tell a young man today about what he should be reading on a daily basis?

Munger: You've got to have a main publication that's using some editorial discretion because you can't read 500 pages. *The Wall Street Journal*, with its editing, is a very convenient thing for me, and I'll bet all of you read it, too. Who doesn't read the Wall Street Journal? Raise hands if you don't read it.

(One hand in the room goes up)

Munger: Why don't you read it?

Audience member: It's a publication I haven't picked up yet.

Munger: What planet do you live on?

Audience Member: I live in Marina Del Ray.

Munger: Well, that may explain it. (laughter) I regard *The Wall Street Journal* as a must-read publication. I don't think it's lost its basic integrity. I think it's a pretty admirable and useful publication. The editorials I always thought were a little nuts. You know, going way back. They were so right wing and so pure. But, it seems to me that the editorials are saner now.

Q: What architectural challenges did you have for the Munger Graduate Residence Hall at the University of Michigan?

Munger: That was interesting. The idea of getting a whole lot of graduate students from multiple disciplines in one big building, which was exceptionally well-located, close to everything, with exceptional common facilities, and to get a bunch of visiting professors and a bunch of fellows (who were sort of equivalent to the Lowell fellows at Harvard), struck me as a very useful thing to do for Michigan. What was architecturally interesting about it was to get that many people on that irreplaceable site, we had to take the windows out of most of the bedrooms. That was not an automatic sale.

What I did, since I knew it would work, is I mocked-up a model. If it hadn't done that, Michigan never would have accepted it [Munger's $110 million donation for the building]. It just sounded awful. No windows in the bedrooms? About 80% of the bedrooms have no windows. That's how we got so many on the site. It costs a hundred dollars more a month to have a windowed bedroom. I'm capable of learning from a little episode like that. In the architectural profession, that ability is usually

lacking. Particularly in a university setting where they're very tradition-bound. But, Michigan was smart: they saw it was right. It's going to be a non-event. Somebody has a fetish about a window in the bedroom, we've got some for fetishists.

Q: What books would you recommend?

Munger: People like you send me so many books, I don't have time to buy my own. Man came to dinner last night, a famous money manager. Brought me three books. I will like the books, I guarantee you. I have a torrent of books coming to me free. I'm a charity case. I actually like a lot of the books because the people have figured me out pretty well. So, I'm living in a very favored world and people give me free books. It was not my ambition in life to get into this position, but it happened, and I rather enjoy it.

Of course, I'm very selective, I sometimes skim. Sometimes I read one chapter and I sometimes read the damn thing twice. It's been my experience in life, if you just keep thinking and reading, you don't have to work.

Q: You mentioned recently that you enjoyed Ron Chernow's book on John D. Rockefeller, Sr.

Munger: Oh, hugely. If any of you haven't read that book, you should read it. That's a wonderful biography. [Titan, by Ron Chernow] It shows how high grade that man was as a business partner. He may have tough on competitors, but as a partner, he was one of the most admirable people who have ever lived. And as a philanthropist — you can actually chart what his philanthropy has accomplished — some of the most remarkable things in the whole history of philanthropy.

Let me give one example. In China, they had deaths by the millions every year. Woman tried to have a second child and their bones just wouldn't enable the child to be delivered. So the terrible, horrible deaths all these young women died, millions of them. Rockefeller sent doctors over there

and they figured out that in 4,000 years of intense farming, they bleached something out of the soil that these women's bones needed. It was pretty cheap to put back. Lo and behold, he did all kinds of things like that.

Just for small amounts of money, doing huge amounts of good. Look at the people who were financed by the Rockefeller Foundation. Very admirable people, the physicists in the 1930′s and so on. He totally revolutionized medical education in the United States with 50 million dollars. He really revolutionized medical education in the world. If you haven't read that book you ought to read it.

It doesn't deal adequately with his philanthropy. But it deals adequately with the way he handled his partners. He would do things like say, "I know this bothers you and it's risky, but I think we have to do it. I'll put up all the money and if it fails, I'll take the loss. If it works, you can buy me out at my cost, so you'll get the benefit." When he did that, the other partners, who were also rich old men, would say, "Hell, John, if you feel that strongly about it, I'll put up my share."

Which is the right way. We had a person do that at Berkshire. The nice Mormon gentleman who sold us the furniture company in Utah [R.C. Willey Home Furnishings]. He wanted to go into Las Vegas and not open on Sunday. Which is not an intuitive decision. He said, "I'm asking you to do something very peculiar for my religion. I'll put up all the money, I'll take all the risk. If it works, you buy it out at my cost, and if it fails, I'll take the loss."

We weren't like Rockefeller. We took the deal. (laughter) That behavior is so rare, so noble, you shouldn't squelch it.

Q: I'm Jason Zweig from The Wall Street Journal. Thanks for the free ad. If you want I can ask Rupert [Murdoch] if he'd like to reciprocate for the Daily Journal. Late in his life, Ben Graham said that in his opinion there was no reason to imagine that an individual investor who thought appropriately couldn't outperform institutions. Do you think the relative playing field has shifted? Do individuals have a greater or a lesser

advantage today?

Munger: In markets as big as this, some shrewd guy who's willing to search out a few places where he has a real advantage will always do well. There's always going to be ways in markets this big for some smart people to figure out something where they'll make money at an unusual rate, just because they're smarter and more diligent. That will never go away.

I don't think there will ever be a universal easy solution where people can do that. The American market is tough now to outperform if you're buying big stocks in big quantities. I think it's a pretty damned efficient market, and I don't say it can't be done, but I just think it's plenty difficult. The evidence is overwhelming that even though there are zillions of people who have tried, the ordinary result is that they don't succeed.

I would hate the job, personally, of investing, say, in positions of a billion dollars each in 200 different stocks in America and outperforming the averages. I would shrink from that with horror. Peter Kaufman said something interesting to me the other day. He runs a very profitable company [Glenair, Inc.] that has very good returns on capital. He said, "You know, if somebody bought my company for three times sales, I wouldn't run it anymore, because I'd have a hard time justifying that price with anything I could do." He's already rich, why should he do something that difficult? He doesn't have to.

I think that's what happened in America. People know their own business is lousy. They know another business that is way better. But it's not better if you have to pay thirty times earnings for it. It gets so difficult that it doesn't work. I figured this out, but the consultants and investment bankers keep selling the same nostrum that you can save yourself by paying thirty times earnings for the kind of business you wish you had, instead of the one you've got.

Berkshire has been a huge exception. In this year's annual report Warren intends to deal extensively with: Why did it happen at Berkshire? Will it

continue? We've reached a size and the record is interesting enough that those are very important questions. If the rest of the world is as smart as I think it is, it will look at this report with great interest.

Part of what we did should be done by others, but it isn't. There are vast institutional pressures on people to do it differently. Will it continue? I think Berkshire's going to continue way better than most people think. Way better. But there's so much power in what we already have. Part of the reason we have a decent record is that we pick things that are easy. Other people think they're so smart, they can take on things that are really difficult, and that proves to be dangerous.

You have to be very patient, you have to wait until something comes along, which, at the price you're paying, is easy. That's contrary to human nature, just to sit there all day long doing nothing, waiting. It's easy for us, we have a lot of other things to do. But for an ordinary person, can you imagine just sitting for five years doing nothing? You don't feel active, you don't feel useful, so you do something stupid.

You'll find that this year's Berkshire annual report very, very interesting. Three failing businesses together created Berkshire Hathaway. There are about the same number of shares outstanding now as they were then. I can't think of anything like it at this scale. You'd think people would be paying more attention to it than they do. I think it looks so peculiar that they can't handle it.

I read an article once by a famous man. I liked it so well (this was twenty-five years ago) that I sent him whatever I could send him without paying gift tax. I sent him $20,000 dollars and said, "I really liked your article, here's a token of my respect." He sent the money back. So, I called him and said, "Why are you sending it back to me. I don't care if you give it to your charwoman or the graduate student who works under you. For God sake's, keep the damn money." Whereby, he took my money and gave it to some graduate student. His basic attitude was, if it was that easy, there must be something wrong with it.

I think that's part of the trouble with Berkshire Hathaway. It looks so damned easy, they think there must be something wrong with it. The people there don't work that hard. They have all these outside interests – Warren's playing bridge twelve hours a week (laughter). They just keep spinning and winning and it just looks too easy. So it's confusing. There must be something wrong with it. (laughter)

Q: What are your thoughts about Elon Musk [CEO of Tesla, SpaceX, SolarCity] and what he's doing?

Munger: I think Elon Musk is a genius and I don't use that word lightly. I think he's also one of the boldest men that ever came down the pike. Put me down as saying I've always been afraid of the guy whose IQ is 190 and he thinks it's 250. I like to think there's a little of that risk with Elon. He is a certified genius.

Q: What daily habits would you recommend practicing?

Munger: I have never succeeded very much in anything in which I was not very interested. If you can't somehow find yourself very interested in something, I don't think you'll succeed very much, even if you're fairly smart. I think that having this deep interest in something is part of the game. If your only interest is Chinese calligraphy I think that's what you're going to have to do. I don't see how you can succeed in astrophysics if you're only interested in calligraphy.

Q: If you were to start another Berkshire, in what form or structure would establish this. A partnership or a C-corp?

Munger: That's a very intelligent question. Berkshire happened by accident. Having a lot of marketable securities inside a corporation with 35% taxes on every gain: No investment vehicle chooses that. It's insane. We just stumbled into it. Now we made it work, but it's a huge disadvantage. It just shows that odd things can happen. The bumble bee shouldn't have been able to fly as well as it did, but it did.

We bought a lot of things that we just held, including a whole lot of private companies, so no capital gains taxes there. No dividend taxes. And, buying so many marketable securities that we just sat on. Not that we don't pay a lot of taxes, but we have a lot of capital gains taxes that are accrued but not paid on the balance sheet.

We made it work, but is it an intelligent system? No, it's insane. The

correct system is to have a partnership. That is such an easy question, I'm surprised you asked it. Maybe you're promoting private partnerships and you knew what my answer would be. (laughter)

Q: Can you tell us about your method?

Munger: Let me show you how my system works. Floated into my account yesterday, some old retirement IRA or something. I got a call: there's 120 thousand lying here, what do you want to do with it? Something I had forgotten about it. You know what I said, the great investor? "Give me your number and I'll call you back." I wanted to invest this money in U.S. Securities. I couldn't think of a no brainer security in my whole brain. I have plenty of things I can do that are okay, but I don't have a big no-brainer.

I think it's hard on the big securities, now. Take Costco [ticker: COST]. Is Costco worth 25 times earnings? I think: Yes. Am I ready to sell any Costco? No. Would I buy more Costco at 25X earnings? I'm probably wrong, but I'd certainly rather buy Costco at 25X earnings than 90% of the other stocks. But I'm so spoiled it's hard for me to buy anything at 25X earnings.

There's no rule I can't have crochets [crochet: a highly eccentric or individual opinion o preference, perhaps akin to 'heuristic' - PD]. I don't have to be totally rational. Don't w all do that? We probably should, as a matter of fact. Certainly a crochet that says this i too hard for me, I'm not going to try to understand it. That's a very useful crotchet.

Q: You mentioned the academic and financial illiteracy in the U.S. There seems to be a reluctance to begin teaching these principals in the education system. What are the possible solutions?

Munger: I think if you expect totally rationality either in humans or human institutions, you're expecting what's not going to happen. What is a little surprising is how stupid academia could be. The capital assets pricing mode is taught as gospel.

I could understand teaching the Bible as Gospel if you're a Christian, but why is the capital asset pricing model taught as if it were a principle of physics? To teach that stuff and have students actually work out problems, the way they would in algebra. Of course it's twaddle. There's a lot of silliness in economics.

Take a simple case. Japan, a modern nation, tried every Keynesian and monetary trick. They print money like crazy. You can't find a pothole in Japan on the side of a mountain, they've got so much stimulus. They had 25 years of stasis. Every economist in the world would have said that's impossible. They have all these tricks we taught them, they're playing our tricks, and they're befuddled. They're trying to solve their problem within this little narrow construct that somebody taught them.

What happened was that Japan rose as an export powerhouse. Right behind them were a bunch of people who were starving in subsistence agriculture and crowded them out of their own market. Think it's fun for Japan to compete with Korea? And China? Of course it got harder in Japan. But of course, the economists can't figure it out. They're looking only at Economics 101. If you're a prosperous businessman and some tough competitor opens across the street, is that good for you? It's not very complicated, you just have to keep an open mind and examine all the possibilities.

Q: What do you think is a pragmatic number of companies to own in a portfolio?

Munger: I don't think there's any one answer to that. It all depends. Obviously if you run an index fund and are scraping money off the top, there's no limit to what you can own. That is a pretty good business. They deserve the success they've had because they outperform people who use the conventional methods.

I talked to a very smart money manager not long ago. I ordinarily don't talk to money managers. I met with this guy because he agrees with me on practically everything, so he must be very smart. (laughter) He told me that he indexes the U.S. equities and he hires managers to work everywhere else. He regards the big time U.S. market as so tough that he's better off just indexing it. He finds more inefficient markets in other parts of the world. I think that's a very intelligent response.

Q: Have you had any thoughts on the recent troubles at Tesco [ticker: TESO]?

Munger: Tesco owned the world for a long time. It looked inevitable. Berkshire bought some. I think Lou Simpson bought it originally, and Warren bought some more. They had a formula that really worked. Then one day it stopped working so well. Partly it was hubris. They thought they were so smart, they could do something difficult that was fresh and easy, and some other adventures like that they found were way harder.

Then the home market got tougher, just as the Japanese had trouble when behind them rose Japan and Korea. Tesla got in trouble when Aldi came in one side and other people came in on the other. It got tougher. How many big companies stay totally on top forever? Maybe Wrigley's Gum.

Basically, the normal result is what happened to Tesco. Listen, Aldi is a tough competitor. Ruthlessly low cost, limited assortment, all private label. It's terribly efficient. You think Costco's any good for the rest of the grocery stores? And Sam's Club? It's a competitive world out there. Somebody is always starting something. Even for the branded goods makers, who looked so invincible for forty years. The natural course of competition is that it gets tough. It's the people who expect everything to just keep going wonderfully who are nuts.

Q: Can you tell us about your partnership with Warren Buffet?

Munger: People don't normally get a divorce after they've been together for this long. We've adjusted to it. (laughter) If we were going to get a divorce we would have done it earlier. I think the honest answer is pretty modest on my part. Einstein needed somebody to talk to. (laughter) As good as he was, needed a talking foil. I've occasionally helped in some other ways, but, basically, you would not want to sit home alone by yourself making the decisions. If Einstein couldn't do it, I don't think you should try it.

Audience member: Einstein had his wife, who was a physicist.

Munger: She was not very good.

Q: What do you think of Obamacare?

Munger: I thought you were going to ask a hard question. All you want to know is have we unraveled the mysteries of Obamacare. I can't do that. If you're an old rich man you can say impolitic things. If I were the benevolent despot of the United States, I would have single payer medicine that people were able to opt out of and buy their own forms of

private care, either from places like Kaiser or from individual doctors. I think we're at a big competitive disadvantage to other countries that don't have this big cost built into their manufacturing. And, I think that paying for medicine per item for all the old people causes a lot of unnecessary treatment. It wastes a lot of money and hastens a lot of death in this country. The medical interventions that are made purely for money are a national disgrace.

Now I've practically offended everybody. Brings out the absolute worst in me. I basically think the existing system is crazy.

Q: Do you think the increases in the standard of living that we've seen in this country for most people are likely to continue?

Munger: I think that it gets harder — just as Japan has troubles being as prosperous as it was against these powerful neighbors with these big populations getting more prosperous and eating Japan's lunch. If you have a system where a lot of people prospered in manufacturing, and you get free trade in rising countries like China, Vietnam, Mexico, and so forth, of course it's going to be harder for the people who had high-paying union manufacturing jobs under the old system.

It's in the nature of things that some people are going up and some people are going down, and it's the nature of politicians to identify anybody who is going down and try to make them feel terribly abused, and to profit personally by exploiting the angst. But there's some angst where the best solution is just to suck it up and cope. In other words, I don't think you can run a country that eliminates up and down distributional changes between groups. I think that's the flux of life.

What are we going to do about it? We live in one world. China comes up. The rise of China has not been good for American unionized textile workers. Now, China can't even make textiles; that's going to Vietnam. That kind of flux is just is natural, and the productivity comes from the fact that people suffer all the creative destruction of capitalism. So they don't like the damn flux when it happens to catch them. But the flux in

total is making the whole boat go up, and the fact that the boat never goes up with every group going up exactly the same all the time is inevitable.

Even if the government controlled everything, they'd still rig the system so some people went and others went down. Just put me down as not too worried about a lot of this modern clap trap.

Q: How do you and Warren balance the need for simplicity with the need to fully understand these complex ideas?

Munger: The interesting thing about Berkshire is that the results are prodigious and the people who are getting the results aren't prodigies. How did non-prodigies get prodigious results? This is a very interesting question that I hope we deal with in the annual report. The answer is: You've got a little better methods. One thing is absolutely essential: You know the edge of your own competency. That really helps and substitutes for a lot of IQ points. You know what you know and what you don't know, and you work it. I've had that concept down. You learn what to avoid.

One of my habits is, I get the no-brainers off my desk immediately. Otherwise it gets cluttered. Some people just pile up the desk and then get totally dysfunctional. I hardly know another human being in the world who's better at this than Jerry Salzman [Daily Journal CEO]. He would have been unable to do what he's done in life without that one trick. He makes a decision, maybe it'll be wrong, but his batting average is very high and the time span is approximately zero. That is just a huge trick to master.

The other thing we do if the problem is really hard and important, we rag it. You keep working at it and going back to it and so forth. You have a lot of time to do that because of all the things you avoid that other people do. We just have a few tricks, and they work so well, but they're not copied so much.

Some of you will get imprisoned. I would hate to be in a place where I had to pretend to believe all the things I don't believe in order to handle my

daily work and discussions. I just described the working lives of practically everybody. But not Warren, not Charlie. Sure, there are a few subjects we'd consider taboo, but mostly we can approach reality the way it is. If you work for some big company there are catechisms, there are all kinds of behaviors that are forbidden. If you're in academia there are all kinds of things constraining you.

Q: I went through One Santa Fe today [a new real estate development close to the Daily Journal HQ], and I'm curious about if you might turn this into a development site .

Munger: We already developed all the property we own. I think we bought these parcels fairly cheaply and we built these very nice, efficient buildings, and we have more than we need. Our business is shrinking. The last thing we're thinking about is developing. If you'd like to rent what we have, contact Gerry after the meeting. (laughter)

Q: I'm interested in your thoughts about how you think about Berkshire's intrinsic value relative to its book value?

Munger: I think Warren's ideas are pretty coherent and pretty right for Berkshire. I've got no disagreement with Warren on that. At a certain price, of course, we'd buy. But as long as we're doing as well as we are, we don't mind buying other things. We don't mind all these bolt-on acquisitions we have. If you ask me how much Berkshire's going to be able to spend intelligently, in just its utility business over the next fifteen years, it's a perfectly enormous amount of money. The chance we won't have a good return on that business is about zero. I think two years from now we will be the biggest utility company in the United States.

We'll deal with our assets at least as well as most people, probably better. We'll have huge opportunities. I like it. The fact that in one state, when we were young and poor, we could find things that paid 12%, and now we may have to make utility investments at 9% or 10%, probably with float that cost us nothing, that's okay. We're slowing down a little. (laughter) We've very favored to have these opportunities when interest rates are

approximately zero. The idea to create more power and transmission and so on and get a guaranteed return on the investment is quite a favorable one to have.

Q: How did the advances in technology affect the natural course of competition?

Munger: Berkshire, of course, has consciously avoided rapid technological obsolescence. We own a railroad, we own a bunch of utilities, we own big insurance companies. Obsolescence is what's happened to the Daily Journal. We had a gold mine here for years. The advance sheets that lawyers need were published six weeks after the decisions were made. We had a big printing press. We could publish those daily, and the lawyers all had to subscribe, and we raised the subscription prices every year, substantially. It was wonderful. We looked like geniuses. Then, the technology changed. Now the lawyers get their stuff over the internet. It's way worse, and that's just the way the world is. So we don't like these technological changes. But at Berkshire we have tried to avoid them as much as we can.

Even where we look highly technical, like in carbide cutting tools [Iscar], we're one of the leaders in the whole world, and it's complicated. It's a good business, and I don't mind the technological complexity where we totally dominate, or pretty close to it. We don't solve the problem of technological obsolescence, we avoid it. I've failed you here at the Daily Journal. I'm sorry.

And, of course, Berkshire's failed in a lot of places. There are all kinds of things that happened to us. We couldn't fix the textile companies in New England. Our jewelry stores are not going to set any records: there are too many jewelry stores, it's just too tough. We haven't found some miracle exemption from the laws of nature. We have ducked a lot of the problems other people have willingly taken on.

Warren said, "We have not learned to jump over seven-foot fences. We found a way to step over little mud puddles and seize chunks of gold on

the other side." You see, there aren't enough mud puddles with gold on the other side, but there have been just enough for us. We work at it.

Q: Why did you feel comfortable grabbing Wells Fargo (ticker: WFC) in the depths of the downturn?

Munger: It was too cheap and we had the money. As a matter of fact, we bought it within one day of the bottom tick, so that was remarkable. You can say I was a little lucky on that. But, it wasn't hard to realize that something was cheap.

Q: . You're going to have a hard time convincing us that you failed at Daily Journal.

Munger: That's an interesting story. We bought Daily Journal for 2 million 7. We took the 2 million 7 back about three or four years later. Everything that's here now is profit. In that sense it's a good record, but it's a not record like Berkshire. It's pretty good for a failing business. (laughter)

Q: How does having low expectations help?

Munger: It's much more fun constantly exceeding your expectations instead of being disappointed. The secret of human felicity is not vast ambition, it's low expectations. Where you really need it is in a spouse. (laughter)

On that comment I'm going to end. (applause)

Charlie Munger's 2015 Daily Journal Annual Meeting - Part 1

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With Berkshire Hathaway's annual meeting showcasing in a few weeks, I thought it would be instructive to hear what was on Berkshire Vice-Chairman Charlie Munger's mind these days. Munger is also chairman of the Daily Journal Corporation (ticker: DJCO), a legal publisher based in Los Angeles, and their annual meeting was held on 3/25/2015. As a shareholder, I just dropped in to see what condition their edition was in.

These notes, while detailed, are far from a transcript. Errors are mine.

Q: I wondered if you could share with us how your vision of Journal Technologies has evolved, and also if you're at the liberty to discuss some milestones in the next 24 months that you're hoping to achieve.

Mr. Munger: That's probably the best question anybody's ever asked at this meeting. It involves the entire future of the company. You set a record for doing the right thing.

[laughter]

What's happened, of course, is that we have a business where the technology and the culture is changing. A lot of the revenues, historically, came from giving lawyers the only practical way they had of getting information. That gave us a monopoly for years and years where we raised subscription prices, and circulation kept going up and up. We had a traditional print newspaper, which was a wonderful business. Then that monopoly went away, as lawyers more and more rely on electronic means for that information.

The other branch of revenue from the traditional business was public notice advertising, where the laws require being published in the newspaper. Of course, those laws were all passed before there was any Internet. Eventually public notice advertising would go the way of the dodos. We had a business on the way to extinction.

A lot of newspapers have faced that problem. A lot have died. A lot more will die, and a lot are limping along. Here, we decided, in what may not have been a terribly good decision at the time, to try and replace our newspaper business by selling software to courts and other government agencies.

That was about like a guy who decided he wanted to climb Half Dome in Yosemite Park, despite of the fact he only had one arm and one leg.

[laughter]

We tried it anyway. Luckily, we had a great boom in foreclosure notices, which gave us a temporary flood of revenue. We used that position to develop this software business, partly by purchase, and partly by self-development. It was a very odds-against-us thing. There's a name for a certain kind of rock climbing – 5/11 – that means it's not really possible, but occasionally somebody does it – and that's what we tried to do here. For some strange reason we're about halfway up Half Dome with our one arm and one leg.

It looks better today than it's ever looked. I would say the difference in our prospects between this time last year and now is enormously improved. Now, it's a game where we're going to continue to spend a lot of money, and we're going to be very conservative about the accounting, and we're going to write off everything we possibly can as we go, etc. But I'd say it has some prospect of working.

It was really, as I've said again and again, a venture capital-type activity, which I hate and isn't why I made my way in life. It's a really difficult honest way to make a living. It wasn't like shooting fish in a barrel, which

is what I prefer. My idea of shooting fish in a barrel, by the way, is to drain the barrel first.

[laughter]

It's really easy, then you shoot, preferably with a big shotgun. This is not what this company has done. But it looks like we may actually do it.

If we're successful it's a much bigger market than the legal newspaper market, which had no way of transferring from state to state except by buying some other local paper. This software business, if it works, will spread over the whole country, and we have a lot of business now spread over the whole country.

It's cost us a lot of money. It's cost us a lot of effort. It will cost us a lot of effort in the future, but I would say the momentum is gaining.

You people who came in as value investors, you've got something else. You've got a damn venture capital type investment.

I don't want to apologize because I'm sharing the same outcome myself, and it looks like it may work. If it does work, it'll be a long, slow grind, but it could be a way bigger business than the print business ever was.

We have now crossed the line. We have more software revenues now than we have from our traditional business.

The fact that it's costing us a lot of money does not bother me at all. I think a lot like Jeff Bezos [AMZN] on that.

[laughter]

I said to the directors, "There's no point in being rich if you don't use it to compete effectively."

I regard it as a total fluke. It isn't what I've done in life. You can argue that Berkshire Hathaway [BRK-A] has created a business from scratch once: the reinsurance department. It's worth a fortune, and is something that

we've done personally.

If we succeed, it's not only good for the shareholders, it's good for the world. This whole system the government uses is very inefficient, and needs a lot of automation. The software is very complicated, and the service is complicated. One of the reasons the opportunity wasn't available was it is very hard going. People like Microsoft hate this kind of business. It's too hard. They have their own way of shooting fish in a barrel.

I kind of like it if it's so hard, because if you win it'll be pretty hard to take away.

Q: You have said that one of the most important things you picked up from Darwin was the value of forcing yourself to search for disconfirming evidence. What important thing did you pick up from Einstein?

Mr. Munger: I didn't know anything about relativity until Einstein

taught me. I wasn't smart enough to figure it out for myself.

[laughter]

Of course, we look for disconfirming evidence. One of the directors said very simply, we should make a list of everything that irritates a customer, and then we should eliminate those defects one by one. Of course, that's the way to compete in a service business. It involves continued fanaticism.

One of the reasons we bought the little company in Logan, Utah, [New Dawn Technologies] is that we liked the service and ethos of the place, and their recruitment methods. Of course, our past accountants, damn their souls –

[laughter]

– just went crazy when we did that. It looked to them like we'd gone stark raving mad. How could it be worth anything? It just bothered them, and they raised hell with us for months and months, and it made our reports late. I feel very good about that acquisition today.

It's a miracle, because we should have failed, but I'm not at all sure we will. Of course, we learn from evolution. You're seeing a perfect example of Darwin: you're watching one business die, while somebody tries to replace it with another. Almost everybody else in the newspaper business that's tried to do that has failed. Some of them bought other businesses, like television stations, with the profits they had, but most of the people who just tried to take their newspaper and transform it into something else, most of them have failed.

That's the common result. I've heard Bill Gates say that in technology that's often the case. Here was Kodak [KODK] that owned the world in silver-based photography. It was the dominant company in the world, the second most important trademark in the world. Armies of Ph.D. chemists, who knew more about silver-based photography than anybody in the world. Fabulous business right through the Great Depression. Total widow and orphan stock. It wiped out the shareholder with technological

change. As Bill Gates said, it happens again, and again, and again, when technology changes enough.

General Motors [GM] was the most important automobile company in the world when I was young. It wiped out its shareholders. How do you start from being the most important automobile company in the whole world, and number two is not close, and wiping out your shareholders? That's very Darwinian. It's tough out there. Some businesses are dying all the time and new ones come up.

Technological change is one of the hardest things to cope with, which is why so many people fail at it. IBM [IBM], on the other hand, went from butchers' scales and what not to totally dominate the early computer market. Of course when the other evolutions came along IBM has failed a lot. It's normal to fail when there's a big technological change. It's hard to adapt to a world that's different.

What's really weird about it, look at the age of these people up here [DJCO's Board of Directors]. We have the oldest board of directors in the history of the world. The youngest one is 60.

[laughter]

The Chairman [Munger] is 91. Should we be climbing Half Dome with one arm and one leg?

[laughter]

But I'm telling you we are. And I don't understand computing.

[laughter]

Q: I wanted to get your opinion on activist investors that got a lot of play in the news this year.

Mr. Munger: I never like the pomposity of the old system, where the board of directors was absolutely permanent and did as it pleased. But

what's happened is what usually happens to me. I like the new system even less.

[laughter]

I don't think it's a great thing for a civilization where the people who are getting richest are a bunch of people who buy a block of shares and howl for change that helps the shareholders no matter what.

I didn't think the old system was perfect, either, but it can't be a great way to run a civilization. Carl Icahn's a very able man, but he should not be running the world.

[laughter]

Q: If you were to redesign an education system, knowing what you know now about what's been important in your life, what ideas would you consider it important to include and to avoid?

Mr. Munger: I have watched some of the smarted people in the world try to improve primary education, and it's proved amazingly resistant to improvement.

[laughter]

I've watched universities struggle. I would say in the liberal arts there's a lot of craziness, and I don't know exactly why.

There's a lot of envy. You have a lot of very bright people who aren't paid very well. Their main power is to give some student an A or a C.

Something makes the liberal arts professors, on average, a little crazy by my standards. I like them, and I probably prefer they marry into the family than people from a lot of other professions, but there's a lot of crazy alienation in the liberal arts professors in the modern world.

I think education is very hard to fix. I think the technical education keeps getting better and better. They keep driving people harder and harder. I

think that's one of the glories of the world. I think the other education is getting better, too, but it's got some very irritating defects.

Q: Given so many kids in your home environment, how did you do all your reading?

Mr. Munger: I have the kind of mind that when I want to read something I can tune everything else out. The people aren't even present. In fact, I frequently sit in a room and converse with dead people while the living people around me are irritated, so I don't think you should try my methods. It's a miracle they work for me.

[laughter]

I will say this: I know no wise person who doesn't read a lot. I suspect that you can read on the computer now and get a lot of benefit out of it, but I doubt that it'll work as well as reading print worked for me.

I think people who multitask pay a huge price. They think they're being extra productive, and I think when you multitask so much you don't have time to think about anything deeply, you are giving the world an advantage you shouldn't do, and practically everybody is drifting into that mistake.

Concentrating hard on something that's important, I can't succeed at all without doing it. I did not succeed in life by intelligence. I succeeded because I have a long attention span.

Q: The U.S. had a $0.9 trillion balance sheet in 2007. Now it's about six trillion. In anyone's lifetime in this room, will it ever go back to $0.9 trillion under the credit economy?

Mr. Munger: Of course, I'm so old I remember coffee at five cents, and all-you-can-eat cafeterias at 25 cents, and brand new automobiles for $600. Over a span of many decades you can count on democracy to cause the money to deteriorate. That will continue because of human nature. It may even accelerate eventually.

Considering the experiences in places like Italy and Argentina and Brazil, I have been pleasantly surprised after the many bouts of inflation we went through. I anticipated more trouble than we actually had.

In my lifetime, over the past 50 years, the common stock averages (including their dividends) produced about 10 percent per annum pre-tax. I don't know what percent of that is real gain, and how much is inflation. Let's say it's seven percent real gain and three percent inflation. I work out those figures as unbelievably good.

Somebody my age has lived through the best and easiest period that ever happened in the history of the world, with the lowest death rates, the highest investment production, the biggest increases per annum that most people's standard of living ever got. The net death rate from war, from everything is better. Steven Pinker is right. It's the most fabulous period that ever happened.

If you're unhappy with what you've had over the last 50 years, you have an unfortunate misappraisal of life. It's as good as it gets, and it's very likely to get worse. It's always wise to be prepared for it getting worse. Favorable surprises are easy to handle. It's the unfavorable surprises that cause the trouble.

In terms of monetary authorities, you can count on the purchasing power of money to go down over time. You can almost count on the fact that you'll have way more trouble in the next 50 years than we had in the last. The technology is changing, so that a few nutcases could make the World Trade Center look like a picnic. We should all be prepared to adjust to a world that is harder.

Q: What do you think about societal change, because of the labor displacement by technology and the accelerating of that.

Mr. Munger: That's an example of what I'm talking about. If you're going to have free trade and better communication, more efficient container ships and so forth, and there's all this new competition from

very talented people who've been held down by stupid governmental systems and Malthusian traps and they're suddenly unleashed, of course that competition hurts the people who formerly were in the privileged position. It isn't because the Federal Reserve didn't do something right, or the politicians are unfair, or the rich people are mistreating the poor. The world has changed. Unless you're going to do away with free trade and modern technology and the liberation of these people who were working in penury on agriculture, of course that's going to hurt the prospects of hard working people with limited education, and it has. It's very hard to fix.

The people are still going, "All you have to do is tinker with the politics and you can fix it." That's what they tried to do in Greece. The Greek solution is idiocy. If we're going to prosper, we have to work. We have to have people subject to carrots and sticks. If you take away the stick the whole system won't work.

You can't vote yourself rich. It's an idiotic idea. Of course, the successful civilizations, they all have a social safety net. Look what happened in Japan. They were the export powerhouse of Asia. Up rose China and Korea, and Germany got way better. All of a sudden they're the export powerhouse.

When you have a wonderful monopolistic position, and then some more talented people work harder, of course you're less rich. These damned economists keep looking for ways to handle the federal reserve system in Japan or something. Think how stupid that is. The solution is really obvious of why they lost. They got huge competition they didn't formerly have when they were the export powerhouse. Japanese were better at quality control and so forth. Then other people learned to play the same game.

Koreans came up from nothing in the auto business. They worked 84 hours a week with no overtime for more than a decade. At the same time every little Korean came home from grade school, and worked with a tutor for four full hours in the afternoon and the evening, driven by these Tiger

Moms. Are you surprised when you lose to people like that? Only if you're a total idiot.

[laughter]

Q: Are there other opportunities for acquisition of technology companies to add to the Daily Journal's existing unit, or are you simply trying to grow that organically going forward? I know you stated that this is not a mini Berkshire Hathaway, but if there was the right opportunity to shoot fish in a barrel, would the board consider it?

Mr. Munger: Our aged board is capable of shooting fish in a barrel, but I don't think we'll get many opportunities. We got an opportunity like that when we bought Wells Fargo [WFC] stock at eight and change. I don't anticipate a lot of future opportunities like that one – I regard that as a one time fluke.

Now it was a the fluke we earned the right to have, by accumulating money from discipline and good service and so forth out of the foreclosure movement. If we happen to succeed in this, which is more likely than not, the experience has not seemed so easy to us that we want to try it again.

If you walk across a river from ice floe to ice floe — where if you fell in the water you're going to die – then you reach the other side where there's prosperity and you look back at that river, I don't think you'd want to step back and try it again. So I don't think it's going to happen again.

We would like something that would help what we're already doing, but we're not looking to be new venture capitalists at our present age. It's an activity we didn't do even when we were young. I don't know why we did it. It was mostly [DJCO Director] John Guerin's idea.

[laughter]

Q: Do you have any morning procedures or rituals that you use, to which you might attribute your tremendous productivity in life?

Mr. Munger: I eat whatever I want to eat. I have never paid any attention to my health. I've never done any exercise I didn't want to do. If any successes has come to me, it came because I insisted on thinking things through. That's all I was capable of doing in life, was thinking pretty hard about trying to get the right answer, and then acting on it. I never learned to do anything else.

All these people who think they are going to get ahead by jogging or something, more power to them.

[laughter]

Q: Do you have any comments on the passing on of Singapore's Lee Kuan Yew?

Mr. Munger: Oh, yes. Boy, I like people who serve me puffballs. As far as Lee Kuan Yew's going, I realized I made a mistake when he died. I'm going to commission a bust of Lee Kuan Yew and stick it somewhere important.

That is the most important governmental leader, the most important nation builder who ever existed in the history of the world. There is no other record equal to Lee Kuan Yew's unbelievable achievement.

A malarial swamp turned into a modern civilized powerhouse, and then using that example to utterly change and transform China. Not only China, but Vietnam. It was the example of Lee Kuan Yew that the North Vietnamese of all people turned to, to turn Vietnam into a powerhouse.

There's never been a career like Lee Kuan Yew's. There was one person in Lee Kuan Yew's high school who was smarter than he was. It was a female, one year older. So he married her.

[laughter]

This guy is very rational and other people went for the lady with the most curvaceous whatever. All his children are successful, and his son is the

prime minister of Singapore.

He had this practical judgment. When he came to power, he was surrounded by Muslims who hated him. He has no assets, no army, no nothing. He's in a dangerous position. He realizes that in his new nation he has to have an army. He asked the world to help him create an army and defense system.

Everybody in the world declines. After all, it's a malarial swamp. One country said, "We'll help you," and it was Israel. He thought, how can I have Israel help me when the Muslims hate Israel, and I'm surrounded by Muslims who hate me. He saw his problem. He accepted help from the Israelis, and he told everybody they were Mexicans.

[laughter]

He totally eliminated bribery. When he went on his anti-corruption kick, one of the first persons that succumbed was one of his best friends. When the guy committed suicide, the wife came to him and said, committing suicide is a loss of face for the family, can we cover the suicide up? He said, "I cannot help you in any way." Lee Kuan Yew was very tough about getting done what had to be done. Singapore was a very corrupt place. His example has caused China to clean up, which looks to me like it's better than a 50% bet. It will be one more unbelievable example of the achievements of the most admirable man – judging by consequences – of any with whom I've shared the planet.

Q: I came to be here from India. It is an honor to be here. What is your advice to a 20-year-old individual who wants to achieve financial freedom through investing?

Mr. Munger: Achieving success through investments has been pretty easy in my lifetime. If you were rational and disciplined, and you had a tailwind of a 10 percent per annum on average from carefully selected stocks going for you, pre tax, that was a big tailwind. If you saved your money, and you lived within your means, were shrewd and so forth, that was enough to take care of you. A little discipline in saving, and the passage of time will do it.

Now, if the world is going to get 10 percent out of indexes in the future, and I don't think it will, in real terms, getting more has proven to be quite difficult. Some of you who come along later are finding that if you stay in the big stocks, it's damn near impossible for most people. When things are damn near impossible, maybe you could stop trying.

That was not my system, but I do not recommend my system to everybody. I do, as a way of life, but I don't think all you have to do is read Charlie Munger and you'll get rich. If it were that easy, this place would be a football stadium.

[laughter]

Mr. Salzman, Daily Journal CEO: Charlie says the way to get rich is to keep $10 million in your checking account in case a good deal comes along.

Mr. Munger: By the way, that was the advice of Howard Ahmanson to a young bunch of starving graduates.

[laughter]

Rich people sometimes get a little pompous.

Q: Would you give us your thoughts on the Posco [PKX] position in the

Daily Journal Portfolio?

Mr. Munger: It's a very interesting example, as a matter of fact, that shows how hard the world is. That is the most efficient steel company in the world, and it had pretty close to a local monopoly of a whole country for a long, long time. In spite of that, in spite of having some very important steel technology they have that nobody else in the world has, Posco is selling like an ordinary commoditized steel company.

It's very hard to avoid being commoditized in high powered competition in the modern world. In places like Dow Chemical [DOW], have all our complex chemical products commoditized in spite of the fact they've got thousands of PhD chemists, and people as talented and brilliant as the people who created Posco just find the markets low and the prices bad and so forth.

It shows how hard and dangerous it is to make money in a commoditized business, and how many businesses that you formerly thought were hugely advantaged can be commoditized. So, you've done a wonderful service to this meeting by raising the case of Posco. Posco's an excellent example for everybody to think about. It really shows how hard it is.

Q: You have said in the past, the private mortgage insurance solution is flawed. Can you talk about why you think the current insurance system like Fannie and Freddie works, and talk about some of the problems with bringing private capital to the mortgage insurance market?

Mr. Munger: You remember what private insurance did in the big financial crisis in the United States. Crazy and immoral, that is not a good combination. They added a third, they were deeply full of pride about the fact that they were crazy and immoral.

And so, they damn near caused a catastrophe. The people who did it have one thing in common, not one has any shame at all. I've never seen anybody who contributed to the creation of the great financial crisis with shoddy underwriting, lousy bonds — I've never met anybody who

contributed to it who was ashamed of himself. It’s always somebody else’s fault, or maybe the government’s fault.

That’s just the way it is. We’ve stumbled by accident, and reacted to a crisis. All the things we did were great expedients, given the terrible problems we had, and it’s working after a fashion. The main risk is, given the political pressures, the government will start going crazy the way everyone did, in reducing the standards and so forth.

You keep trying to enable your citizens to vote themselves rich by various stratagems, like unlimited credit to people who don’t deserve credit, which is really a dumb idea. You’d think people would know that by now, but I don’t think they do. I’m satisfied with the current system provided they keep the standards up.

But of course, they don’t want to do that, they want to lessen them as fast as they can, and that’s what the politicians will keep urging them to do. I think it’s a terrible idea. I don’t think there’s anything wrong with having a conservative system, like the FHA was in the Great Depression, that happened to involve the government. Letting private agencies and private insurance do as they please? We’ve shown how well that works, our unregulated, wonderful people in finance. I’d rather trust some pathogens.

Q: I'd like to get your thoughts on American Express [AMEX]. Do you think its moat has narrowed recently?

Mr. Munger: I don't think it was desirable that it lost its contract with Costco [COST]. Again, that's an example of what tough capitalism is. Obviously, other people are willing to do it cheaper. It just shows how tough a position that looks impregnable can be in modern capitalism. It's what makes everything difficult.

To those who already have some money, I think that's just the way it is, and American Express has had a long period of very extreme achievement and prosperity. I think they'll have a lot of prosperity in the future, but it doesn't look quite as easy as it once did. Now, the head guy would say it's always been hard, he's been battling hard, but we paddled hard here too, and what good did it do us in Daily Journal's print business? We paddled like crazy, didn't we Gerry?

Mr. Salzman: We tried. It was hard.

Mr. Munger: Yeah, what happened is you just keep receding and receding. Welcome to adult life.

[laughter]

Q: I recently watched an Elon Musk interview on YouTube, in which he said he had lunch with you and you had given him all sorts of reasons why Tesla would fail.

[laughter]

Would you be kind enough to educate us why you thought Tesla would fail, and what BYD [ticker: BYDDF] can learn from this?

Mr. Munger: I think the auto business is very difficult, very competitive, and everybody is going to make wonderful cars. Everybody already has enormous size and wealth. So, I regarded it as a tough business. Elon Musk is a genius, and so if anybody has a chance to do it, he probably is the man.

But we have a saying at Berkshire that when a man with a reputation for genius takes on a business with a reputation for tough operating conditions, it's the reputation of the business that's likely to prevail. Without government help, getting electric cars off the ground is really hard. In China, it works a lot better than it does here, because their air is worse.

What Elon Musk really needs is for the whole country to have a disastrous smog attack that kills a lot of people. Short of something terrible like that, I think it's going to be difficult. He's a genius, but is going to have to be.

Q: I'd like to ask you how you read, and how you retain and incorporate that information? Do you have a filing system?

Mr. Munger: No, I've never taken notes; I never kept notes when I was student. I would just read what I pleased when I felt like reading it, and I think what I think when I feel like thinking it. That's my system.

[laughter]

I don't think it's the right system for everybody, but it seems to have worked well enough for to get by.

Q: My question is about so called 'robo advisors'. What are your thoughts on the subject?

Mr. Munger: The robo funds are the index funds, the big ones. You can hardly imagine more of a robo fund than an index fund. Of course, they're beating a large percentage of actively managed money over a long period of years, particularly the people who are managing billions. I just thank God that they didn't give me the assignment of managing $200 billion and beating the indexes. I would not have welcomed that challenge.

The people who still have value in investing are people who are willing to work very diligently and intelligently in less efficient markets. I think it is hard to be a great value investor with $200 billion under management. It takes a long time to buy in, a long time to sell out, other people copy your trades, it's very difficult.

Q (Phil DeMuth): Financial economists in recent years have rediscovered that highly profitable, high quality companies are better investments than other companies. They try to figure out where this idea came from, it takes them back to Buffett, and then Buffett points to Munger. But this is an insight you had in the 1950s, or maybe the early 1960s, when you were an attorney. How did you come upon this idea? You weren't even Charlie Munger then.

[laughter]

Mr. Munger: Everybody with any sense at all knows that some companies are better than others. What makes it difficult is they sell at higher prices in relation to assets, and earnings and so forth, and that takes the fun out of the game. If all you had to do was figure out which companies were better than others, an idiot could make a lot of money. But they keep raising the prices to where the odds change.

I always knew that. They were teaching my colleagues that the stock market was so efficient that nobody could beat it. But I knew people who beat the pari mutuel system in Omaha by knowing more about horses than other people. I knew it was bull. When I was young I never went near a business school so I didn't get polluted by the craziness.

[laughter]

I never believed it. I never believed there was a talking snake in the Garden of Eden. I had a gift for recognizing twaddle, and there's nothing remarkable about it. I don't have any wonderful insights that other people don't have. I just avoided idiocy slightly more consistently than others.

Other people are trying to be smart; all I'm trying to be is non-idiotic. I've found that's all you have to do to get ahead in life, be non-idiotic and live a long time. It's harder to be non-idiotic than most people think.

Q: As chairman of a major hospital, can you speak to us about Obamacare?

Mr. Munger: That's one of the most complex subjects on Earth. Of course, the system of medical care that's evolved in the United States has much wrong with it. On the other hand, it has much that's good about it, all new drugs, the new devices, the new operations.

Medicine has taken more territory in my lifetime than it took in the whole previous history of mankind. It's just amazing what's been done, and a lot of it has been obvious and simple, like inoculating children against infantile paralysis, scraping the tartar off your teeth so you don't wear plates when you're 55 years old, so on.

People now take those benefits for granted, but I lived in the world where a lot of children died, and every city had a tuberculosis sanitarium, and half the people who got tuberculosis died. It's just amazing how well medicine has worked. On the other hand, compared to the best it can possibly be, the American system is pretty peculiar.

It’s very hard to fix, because one kind of incentive is to pay so much a month for taking care of the people, and everything you save is yours. That is the system the government uses in dealing with convalescent homes. That’s a great name, the ‘convalescent home’. You convalesce in Heaven; you don’t convalesce in that home.

[laughter]

It’s tempting to have this euphemistic name. But that creates huge incentives to delay care and keep the money, and the government has strict rules and compliance systems and so forth. If we didn’t have that system, the cost of taking care of old people in convalescent homes would be ten times what it is. It was the only feasible solution.

The rest of the world is going in that direction because the costs just keep rising. If the government is going to pay A anything he wants for selling services to B, who doesn’t have to pay anything? Of course that system is going to create a lot of unnecessary tests, unnecessary costs, unnecessary procedures, unnecessary interventions. Psychiatrists that keep talking to the patient forever with no improvement.

Of course that system is going to cause problems, and the alternative system also causes problems. Now, add the fact that you’ve got politicians, and add the fact that you’ve got existing players who are enormously rich and powerful, who lobby like crazy. A state legislature now, with a huge percentage of GDP going through the medical system, just imagine what the lobbying is like.

So, we get these Rube Goldberg systems, and we get a lot of abuse of various kinds. There’s hardly an ethical drug company that hasn’t created multiple gross abuses, which in substance go into the bribery of doctors, which of course is illegal. They’ve all committed big follies.

The device makers, if anything, have been worse. There’s been a lot of abuse and craziness, and the costs, of course, just keep rising. That’s in a system that averaged out as the greatest achiever in the history of the

world. It’s very complicated.

I think it will get addressed and we probably will end up with systems that are more like we do with the convalescent homes. If you look at medicine, what’s happening is that more and more they’re going to a system where they pay somebody X dollars for everything they say they need.

That system has some chance of controlling the cost. If you go into a great medical school hospital today, and you’re within one day of dying of some obvious thing like advanced cancer, the admitting physician is very likely to ask for a test of your cholesterol and every other damn thing, and all the bills go to the government.

As long as incentives allow that, people will do it, and they’ll rationalize their behavior. Something has to be done on that, more than is now being done. I think the drift will be more in the direction of block care. I don’t see any other system that would have controlled cost in the convalescent homes.

By the way, your doctor can’t just walk by every bed in the convalescent home and send the bill to the government. That’s not allowed by the law. But if you transfer the patient into the hospital, you can walk by the bed five minutes every day, and send a $45 bill to the government.

If the incentives are wrong, the behavior will be wrong. I guarantee it. Not by everybody, but by enough of a percentage so that you won’t like the system. I think that’s enough on a subject that’s so difficult. We can see where it’s going. In the Netherlands, they have a system where the same people are giving a free system to everybody and a concierge system to the others. It’s actually working pretty well, so that’s a possibility.

Q: A question in regarding to the Asian population in the United States. A disproportionate number of us go to elite universities in the U.S., and a lot of us have upper ranked performance in school and have better jobs after school, but very few of us make it to the top of the field, especially in investing. Why do you think that is the case? What’s working against us

in this nation?

Mr. Munger: No, what's working against you are the laws of arithmetic. It's a strange thing, but exactly 99 percent of the people are at the bottom 99 percent. That will always be true no matter what. Of course very few people will get to the top 1 percent. In fact, only 1 percent gets there.

[laughter]

Q (Whitney Tilson): As a long time Berkshire shareholder, I was delighted to see the latest deal with the 3G guys announced last night. I understand you may not be able to comment on that specifically, but could you just talk about your experience with Heinz and with 3G and what you hope for the future? What's so special about these guys that they're able to squeeze out such extraordinary performance out of fairly stable, slow growth businesses?

Mr. Munger: Through enormous discipline, enormous will, and enormous intelligence, 3G has adopted a zero-based budgeting system which is more extreme than anybody else's. Yet they've been able to do it time after time in a way where the place ends up as strong or stronger after they've removed a lot of the cost. Of course, that's a very interesting example.

The same thing went on in the nonprofit center. When the great financial crisis came, every university I know of laid off 6 percent, 8 percent, 10 percent of their people. I know of no case where the university didn't work better after they got rid of the 10 percent. None. Zero. Successful places tend to get bloated, fat, complacent. It's the nature of human life.

Somebody who is tough enough, shrewd enough, who knows enough not to cut the wrong things and to do everything fair, has an opportunity to buy things and cut out expenses they don't really need. 3G is probably the most extreme large operation in the world doing that.

I actually think they will probably end up increasing the sales as well. What's interesting about 3G is they're teaching us something about

reality: namely, that successful places contain a lot of unnecessary people…I could have told them that by observing them. If you went into the Department of Agriculture, would you have the feeling the thing was understaffed?

[laughter]

I think you'd find many a corporate headquarters going, "What in the hell are all these people doing?"

Now the Daily Journal I do not think is overstaffed. I don't think it ever has been. Gerry, what's your comment on that? He's watched it all these years. I don't think we've had a lot of unnecessary costs ever.

Mr. Salzman: We haven't had a lot of unnecessary costs. At one time, the Daily Journal by itself had approximately 300 employees. Now, we have about 150 employees. You can see that we have taken the direction of the company and reduced expenses accordingly.If you take the foreclosure business, which went from about 2006 to 2011 just like that, we added one and a half people to handle all of that additional work. When the boom went the other direction, we eliminated the one and half plus maybe a little bit more. So we tried to be ahead of the game in terms of anticipating and certainly using technology, because that's the way we were able to handle that particular sequence of events.

Mr. Munger: But, normally, if you're super successful, if the sky rains gold, everybody's president gets an assistant. Pretty soon, the assistant has an assistant. It's just the way human nature works. It's like cancer. Somebody who's really tough about that can remove a lot of costs, but only from certain kinds of companies. 3G would perish if it tried to reduce a lot of costs at the Daily Journal. They would starve to death.

[laughter]

Q: Indexing has grown a lot in the last 30 years. You once said that if we ever get to the point where everybody's indexing, it's not going to work very well.

Mr. Munger: It's far enough away from happening so that I don't spend much time thinking about it. I think human nature is such that it will never happen. I don't spend much time thinking about what is almost certain never to happen.
In the world as it is, indexing has gained a lot. It probably should have gained a lot, because it's quite rational. It's bad for a lot of people who would otherwise be earning money as stock pickers. It probably should have been bad for those people.

It doesn't make it pleasant to have it happen, any more than it helped Japan have a pleasant time when Korea came up so fast as a competitive powerhouse, and even more so when China rose. But I think indexing is here to stay.

If you stop to think about it, civilized man has always had soothsayers, shamans, faith healers, and God knows what all. The stock picking industry is four or five percent super rational, disciplined people, and the rest of them are like faith healers or shamans.
And that's just the way it is, I'm afraid. It's nice that they keep an image of being constructive, sensible people when they're really would-be faith healers. It keeps their self respect up.

[laughter]

Q: Charlie, I'm here from Sydney, Australia. I'd like to just come back to Lee Kuan Yew. What are the chances of that culture continuing with the current government and future governments of Singapore?

Mr. Munger: They're pretty good. Lee Kuan Yew left a base, eliminated the corruption, made it hard to get in, and paid the people a lot. There's no real incentive to steal in Singapore. Either in Parliament or as an advanced government administrator, you get paid very well, and you're admired, and so forth.

I think what he's left in Singapore will continue to do very well. But of course, he rose when he was doing it and China wasn't. Now Singapore has to compete with China. China makes it harder.

Q: What about the changes since his son or predecessor came in, for example, allowing casinos to come into Singapore…

Mr. Munger: I would have hated that. You make so much money running a casino, compared to any normal human business. There are no inventories, it's like having license to print money, and people just can't stand the temptation. So, he organized a casino business. Only foreigners can play; he didn't want to ruin the locals. I would not have slept with the devil that much. But Yew was no longer really in power when that happened. If he'd still been young, I'd like to think he would not have done that.

I do not consider it desirable in the United States that we've created casinos and lotteries everywhere. That was not a desirable development in an advanced civilization, and the damn politicians that solve their short-term problems by bringing in this poison deserve to be in the lowest circle of hell. That means that I'm consigning practically all of them, since practically all of them have done it. I can hardly find a place where they aren't putting in new casinos. And the advertising on TV is happy people winning at the table.

[laughter]

Talk about false advertising! You should look at the desperate faces of people trying to get even at the table. Imagine making your living putting those kinds of images on television.

Q: How do you deal so well with failures and upsets and disappointments?

Mr. Munger: I have so many fewer.

[laughter]

It's very simple. An isolated example that's very rare is much easier to endure than a perfect sea of misery that never ceases.

Q: Recently you've written about the benefits of trust….

Mr. Munger: Oh, it's just so useful dealing with people you can trust and getting all the others the hell out of your life. It ought to be taught as a catechism. The trouble with doing it is, in an ordinary school, you'd immediately cast 40 percent of the people into oblivion.

Nobody would even talk to them, and I'm not sure an egalitarian civilization is willing to be that tough. But wise people want to avoid other people who are just total rat poison, and there are a lot of them.

Q: How does someone earn that trust?

Mr. Munger: You do it partly by experience. The simplest way to get trust is to deserve it, and just keep deserving it.

Now, the casino has tried to deserve trust by having a happy winner up there on television, but do any of us trust casinos? Would any of us say, oh goody, when the daughter brings home a boyfriend who makes his living in the credit department of a casino?

[laughter]

And by the way, a lot of our major capitalistic institutions that parade as

really respectable, they're just casinos in drag. What do you think a derivative trading desk is? It's a casino in drag. People feeling they're contributing to the economy, and they're managing risk. They make the witch doctors look good.

Q: About 20 years ago you gave a talk on the investment management of the endowment funds for nonprofits, colleges, and so on. Many people in the pension and endowment fund business are now following the Yale model, the so-called David Swensen model. This recommends a significant percentage of assets toward hedge funds and private equity. And I think recently I heard you say on a television program that if you were managing endowment funds, you would have it virtually all in common stocks.

Mr Munger: I don't manage endowment funds, and I don't like the politicization that exists in places like big state pension funds and so forth. It's very difficult to manage umpteen–billion dollars. Since David

Swensen was so extremely successful at Yale, of course the system has spread. Any successful system will spread by example.

The other thing that's spread is the leveraged buyout system, and those people actually have an advantage in a world like the one we have. If common stocks are yielding 10 percent average over time pre-tax? And you have a different way involving investment in which you use leverage, and you also eliminate some unnecessary costs, like 3G, and a few other tricks. Just with the financial engineering, you have a natural advantage. Of course they'd have wonderful experience in selecting the top 25 percent of the LBO funds, and have served their endowment clients very well. That is part of what people like David Swensen did.

When it gets to hedge funds, Warren has been famously skeptical about trillions of dollars in hedge funds, and I think he's right. I think there'll be a lot of very bad experience. There will also be some good experience. A few people have been able to select a few advisors for some of these private equity things where they really done well by being shrewder.

Some of the money they made at Yale or Harvard was actually made shrewdly. They used leverage. I wouldn't have done it myself, because I don't like balance sheets swelling with vast amounts of leverage. I'm afraid of human nature.

Nonetheless, a lot of what they did was quite shrewd, and of course they did have large returns. I don't think it's easy to do. I don't think anything any ordinary person can do easily is likely to work that well. What David Swensen did, with the aid of Yale's reputation and his own, was select some of the smartest people around.

It was a like a guy who figured on how to make successful plays on Broadway. The fact it succeeded doesn't mean it was easy. He did something very remarkable and of course the example spreads. I don't think there's any real easy solution for anybody. Anything that's really likely to work, is likely to be hard.

Q: What do you think of new Internet platforms for starting companies such as Kickstarter?

Mr. Munger: I don't know anything about new Internet platforms.

[laughter]

Q. All right. What advice would you give for early entrepreneurs, young game changers, in the old way of thinking?

Mr. Munger: I don't know anything about the new world of managing a big network based on computer science. It all came up and developed after I was convicted in my habits, to then go back and learn to play a different game. What I was doing worked well enough, so I didn't feel deprived. I let it pass.

I wish everybody well who's good at it. I feel the same way about a guy that walks across the tight rope over Niagara Falls. It's his way of making a living, but I'm not inclined to try it.

[laughter]

I'm not trying to outdo Page and Brin at Google, and I don't have any advice for young people who want to get rich. Basically, I think the desire to get rich fast is pretty dangerous. My own system was to get rich slow.

It protracts a rather pleasant process, so I recommend my system to everybody. After all, if you get rich fast all you can do is be robbed by your own employees and your yacht and so forth. Whereas if you get rich slow you amuse yourself over a lifetime.

[laughter]

My advice to you is to go to the "get rich slow" system.

Q: I'd be curious about your thoughts on long-term defensibility. Any themes you've distilled from the thousands of companies that you invested in?

Mr. Munger: We tend to look for easy decisions, and we find it very hard to find easy decisions, but we've just found enough barely to handle our own problems. I don't have a system. Since I barely have enough for myself, I do not have a vast surplus to give to the multitudes. I'm not holding back on you, I just don't have them.

[laughter]

Q: In the past you mentioned how you didn't want to use up the U.S.'s hydrocarbons. Now it's seems like the world is awash in oil. Could give us your updated thoughts on the global oil market.

Mr. Munger: You'll be surprised to know that I've not changed my mind.

[laughter]

I think the hydrocarbon reserves in the United States are one of the most precious things we have, every bit as precious as the topsoil of Iowa. Just as I don't want to export all the topsoil in Iowa to Iran or someplace, just because they are willing to give us some money, I love the hydrocarbon reserves we have in the ground. The fashion is to be independent and to use them up as fast as we can. I think that's insanity as a national policy. I must in a minority of one percent tops, but of course I'm right.

[laughter]

We have no substitute for those hydrocarbons. We use them to make our fertilizer. It's chemical feedstock. We are not going to be able to run our airplanes without hydrocarbons. We do not want to use that all up. It's finite. It's not at all safe to assume there's a substitute.

They have a long record over time of appreciating in value. We're just damn lucky we didn't learn fracking earlier to remove them all or we would have done it. But everybody else just has the idea that anything that happens in the free market is all right even if it's an ax–murder.

[laughter]

They think exporting hydrocarbons makes sense. I think it's a ridiculously stupid policy, but if you have a little oil lease, of course you want to export, but I don't think it's good for the country at all. I love the fact we have a lot of hydrocarbons left that we haven't exploited.

Why wouldn't you be pleased to have it? How happy would we all be if we were importing 100 percent of our hydrocarbons right now, like Japan? We'd feel exposed and in danger. We'd be right to feel exposed and in danger.

Will we feel like some big power in the world that might prevent other people from misbehaving if we have no hydrocarbons at all, if we are dependent on others? No, I think the fact that that idea is so unconventional doesn't mean it's wrong. It just means other people don't think very well.

[laughter]

Q: Going forward, what unexpected or under–appreciated changes changes do you think are most relevant, and which industries do you think will be most unhappy?

Mr. Munger: I think the one that affects the next 50 years for young people: it's very unlikely that we won't have some major catastrophes. I think we've had a very favorable period, but I don't think it's terribly constructive to spend your time worrying about things you can't fix. As long as when you are managing your money, you recognize that a terrible thing is going to happen, in the rest of your life you can be a foolish optimist.

Benjamin Franklin said a very wise thing. He said, "You keep your eyes wide open before a marriage and half shut thereafter."

[laughter]

I think those are catastrophes that you can't fix. Franklin is right, keep your eyes half shut. I think that's what most of us do anyway. Though I think that's the change that's most likely.

I don't see how we bring back that age where an uneducated man can march ahead rapidly. As long as we have free trade and worldwide competition, and I don't want to stop having free trade with a big nuclear power like China. China and the United States have to get along. Each country would be out of its mind not to get along with the other. I think trade helps us to get along.

If it hurts some people, life is always going hurt some people in some ways and help others. There should be more willingness to take the blows of life as they fall. That's what manhood is, taking life as it falls. Not whining all the time and trying to fix it by whining.

Q: One of the more peculiar things that we see in the markets today is the existence of persistent negative interest rates on certain government bonds. I'm wondering if you just have any thoughts around that.

Mr. Munger: This has basically never happened before in my whole life. I can remember 1½ percent rates. It certainly surprised all the economists. It surprised the people who created the life insurance industry in Japan, who basically all went broke because they guaranteed to pay a 3% interest rate. I think everybody's been surprised by it, including all the people who are in the economics profession who kind of pretend they knew it all along. But I think practically everybody was flabbergasted.

I was flabbergasted when they went low; when they went negative in Europe – I'm really flabbergasted. How many in this room would have predicted negative interest rates in Europe? Raise your hands.

[No hands go up]

That's exactly the way I feel. How can I be an expert in something I never even thought about that seems so unlikely. It's new territory….

Q: Are there any specific unintended consequences that you are concerned about now that we've had such a prolonged period of low interest rates, which are clearly altering folks' risk behavior?

Mr. Munger: I think something so strange and so important is likely to have consequences. I think it's highly likely that the people who confidently think they know the consequences – none of whom predicted this – now they know what's going to happen next? Again, the witch doctors.

You ask me what's going to happen? Hell, I don't know what's going to happen. I regard it all as very weird. If interest rates go to zero and all the governments in the world print money like crazy and prices go down – of course I'm confused. Anybody who is intelligent who is not confused doesn't understand the situation very well.

If you find it puzzling, your brain is working correctly.

Q: This is the fiftieth year for the Berkshire Hathaway report. You and Warren each wrote a letter that neither had read before. I'd just like your comments on what you thought of Warren's.

Mr. Munger: I think Warren's letter was very, very useful. I particularly liked it where he was criticizing banks. Take the growth of the conglomerate movement which is sort of a chain letter game that people played with financial accounting. The accountants all blessed it. The accountants never should have blessed the conglomerate craze, with constantly buying low quality earnings and making the earnings go up.

It was an evil system and an evil way to make money. It was an evil way to run an accounting profession to bless the outcomes. Nobody else was talking that way. I tend to admire Warren when he gets off on important subjects like that, where he's totally right. The chances that anybody will pay a lot of attention to him in a way that changes anything is, I think, quite small.

For a few of the cognoscenti, like you people, how many of you approve of the way, say, IT&T played the conglomerate game where their accountants blessed their earnings reports? Raise your hand if you thought it was wonderful.

[no hands go up]

The answer is it wasn't wonderful. I liked what Warren did. Nobody else is doing it. What other CEOs are saying that American financiers and their accountants grossly misbehaved for a long time? Nobody. I think it's useful when somebody does that. And he's totally right. It was awful, the fact that everybody went along with it, including the investment managers. It's still happening.

However bad you think it is, somebody actually comes by and does it worse. It wasn't moral the first time and the second outcome is not better. People are enthusiastic about it. I'm holding my nose. That's the only correct response.

Q: What do you think is the least talked about or most misunderstood moat around a business ?

Mr. Munger: Everybody would really like to have a misunderstood moat. You're the greediest fellow that's spoken.

[laughter]

All you want to know is if I have a moat that you can understand that other people don't. A modest wish.

[laughter]

You're going to ask a 91-year-old man how to do it? Reminds me of one of my favorite stories. A young man comes to Mozart and says, "With your help I want to compose symphonies."

Mozart says, "You're too young to be composing symphonies."

He says, "Look, you were doing symphonies when you were 10 years of age. I'm 21."

Mozart says, "Yes, but I wasn't running around asking other people how to do it."

[applause]

Q: What are the customers' problems that Journal Technologies are trying to solve?

Mr. Munger: Every government department needs all kind of automation it doesn't have. It's complicated. The systems interact with other systems. Software is more and more important. It's very difficult.

The governments have their own way of doing businesses that are created by history, local legislation, and so forth. There's nothing simple about it. A company like Microsoft got in a business somewhat similar to ours when they bought Great Plains Software, Inc. They've succeeded with it

moderately.

Even Microsoft finds it difficult to do anything but have moderate success when they buy some thoroughly proven software system — more or less similar to what we're trying to do. There's nothing easy about it. But it's very necessary. It's a huge market. The right idea, of course, is to really serve the customer correctly. Somebody's going to win.

Q: I'm curious whether or not you see any parallels between what's happening today in television and what's happened to the newspaper industry.

Mr. Munger: The newspaper industry, of course, is easy. It had a revolutionary change in technology. The worst single thing was to take the classified ads out of the paper, because that was the total goldmine. I don't think that's fixable.

Our newspapers were impregnable local powerhouses, and very constructive parts of the political system of the country. Of course, they've gradually been enormously weakened. That was not good for the country. It happened by accident. We lost all these local powerhouses that could have total integrity, because they had impregnable financial positions.

Television is different. I've been a little surprised how well the old broadcast networks have survived the new world of the Internet and cable television. I'm not sure I understand the situation well enough to predict what's going to happen over the next 25 years.

Something happened recently, which I watched in China. When the Berkshire Hathaway Annual Report came out, it created a great buzz in China. China is interested. We look Confucian to the Chinese. They like elderly rich men.

[laughter]

We're trying to be wise. That's the Chinese system. There was a great buzz of the Berkshire report all through China. All of a sudden, the buzz

stopped.

What happened? One woman in China took $150,000 of her own money and a year of her life and created a documentary film. She ran the thing over the Internet.

It was a film. She got 200 million views. What she did was a long thing about smog, how the people were dying in China, and how Los Angeles fixed its smog problem by taking sulfur out of the air when people burn coal and oil and so on. Terribly well done.

This one woman is changing the policy of China. She isn't on the newspapers. She isn't on the television stations. Nobody had ever heard of her.
One damn documentary. That is a new world. That's a new source of power. I don't know where a world like that is going to end up. I just know it's different. It's important. In this case, it was very constructive.

China has been dead wrong to allow people to die 10 years early in Beijing because the air is so lousy. Immoral and stupid: not a good combination. China's going to fix it. This woman is actually helping, with one film.

The world changes like that so rapidly. It's hard to know who's going to have the power and what's going to happen. That's the way I feel about a lot of the media. I understood it better when the people who had the printing press controlled the newspaper, and the people who had the network allocation controlled the broadcasting.

Frank Murphy [of Murphy Radio, founded 1929] liked it better when broadcasting was all black and white, and there were only three networks. He had a big, strong position. He did not welcome all the new competition.

I do not understand how they get so much information through space at the same time.

You and I grow up in a world where these radio stations interfered with

one another. That's why you couldn't have very many channels. Now, one woman can put 200 million hits on a whole damn movie through God knows what. How do the bits not conflict with one another?

[laughter]

It's very complicated. I don't understand it. I understand peanut brittle.

[laughter]

Q: What has surprised you the most about human nature?

Mr. Munger: The one thing that has surprised me all my life is how many people with high IQs do massively stupid things. It happens everywhere. But it is surprising how extreme the stupidity is and how talented the people are who do them. I think the human mind was almost made to malfunction in a lot of different ways. It makes the world a very dangerous place.

The man whom you trust, he's your physician, your doctor, you investment manager, what have you, can go plum crazy. To give you an example:
I'm used to doctors who think a procedure that's good for them is good for you. But in Redding, California, a couple of doctors rose who gave everybody who consulted them open heart surgery. They really convinced themselves that everybody needed open heart surgery. A normal heart was a widow maker. If they replaced it with carbon, nylon, or something, they were way better off.

They did massive amounts of open heart surgery. By the way, their surgical results were wonderful. Nobody survives open heart surgery better than the guy who doesn't need it at all.

[laughter]

I expect the worst in human nature. But they thought they were doing the right thing and really helping the patients. That surprised me.

It seems impossible. How could anybody behave that way? How could it go on for year after year? Hospitals were sending their executives up there to learn how to run their hospitals this way.

[laughter]

They were making money and achieving status and demonstrating skill. But it's so extreme, you think that couldn't happen. If it did happen, you think it would be identified by other people early. It ran on for years. And their bosses were trying to get their other hospitals to have the same results. Amazing.

Q: Were they sued?

Mr. Munger: Of course.

[laughter]

They did take away the doctors' licenses, but nobody went to jail. You'd think they'd go the lowest circle of hell, but they didn't. They lost their licenses.

Q: When might you believe the software industry will catch up with the law profession in the form of reduced billable hours due to the processes and systems?

Mr. Munger: I wouldn't hold your breath.

[laughter]

I do think there is some trend to limit the idea of hiring a lot of young people and have them all go 13 hours and so on, trying to increase the billable hours. That is not just the law profession. The consultants do it. The accountants do it. Lots of people do it.

It's human nature operating. But I do think in law you're seeing the elements of rebellion. Some clients are insisting on different systems. It's gone too far.

Q: In China there are debates about if China should learn Singapore's management style, because this type of management style might work in a tiny place like Singapore, a city-state, but not in a big country like China.

Mr. Munger: What China adopted from Singapore was not its total management system. It adopted its system of an economic management business. It had private ownership of business. Before that, the Chinese government had owned practically everything.

They took part of what Lee Kuan Yew had done in Singapore. China's weird combination of authoritarianism and free enterprise has worked wonders for its economic output. Lee Kuan Yew's example had a lot to do with it. But he didn't think necessarily that was right for a small City State, was right for a whole backward country of a different nation.

Nobody thinks that it's his exact solution, but I do think the anti corruption part of China was right out of Lee Kuan Yew's book. China had a lot of corruption.
China increased its GDP at 8, 9, or 10 percent per annum for decades. They weren't perfect, but it was a lot of achievement from where they started.
What's really interesting is how much influence on this outcome one human being had. He started as a leftist labor leader. It's perfectly amazing. I wish it could happen more often.

[laughter]

Q: What methods would you use to quantify the appropriate amount of debt in an investment, whether it be real estate, private equity, or a public corporation?

Mr. Munger: The appropriate amount of debt varies with the circumstances. I don't have any general rule. Generally speaking, if you're investment is uncertain, say, as running a big complicated enterprise, there's a lot to be said for having a lot of extra wealth and liquidity.

You're a huge social safety net if you're a controller of capitalist power. Do we want them all to be leveraged to the gills so we can buy back the maximum amount of stock? They are big social enterprises that should have reserves of safety.

The idea that they should all leverage themselves to the gills to please a bunch of activists would be like taking all the safety margin out of bridges on the theory we'd save steel. That's a dumb idea.

Q: Could you speak about the growing market share of indexing and the effect that will have on the relationship of shareholders to the companies that they own.

Mr. Munger: It's likely to have a significant effect over time, because now you get a bunch of permanent owners. The people who run the index funds are now, in effect, permanent owners. They can't sell. Yes, of course,

they will drift into using more of that power. Will it be used intelligently, the new power? I doubt it.

[laughter]

Q: Can you speak to the general level of market prices today? If you had all your money in a tax deferred account, would you be tempted to increase the level of cash?

Mr. Munger: You're asking me for a position I don't occupy in life.

[laughter]

If you said, "Charlie, how would you practice dentistry if you've been a dentist?" I may not be able to give you as good an answer as I could about something I thought about a lot. I'm content owning virtually 100 percent stocks, but I really think that I own stocks that are better than other people's on average.
Therefore, my decision is easier. What I would have to do if I had to own average stocks like everybody else, I'm not so sure. I've carefully avoided that fate.

[laughter]

I've been able to do it for a lot of decades. Now, the margins are not what they used to be, but an old man is lucky to have any advantage at all.

[laughter]

Q: Do you think companies like Google and Apple have long lasting moats, considering that they are right at the center of technology?

Mr. Munger: I am not an expert on the moats of technology companies. The reason, by and large, I don't own them is because I do not understand whether or not there are moats that will last or not. I do think Google is a very remarkable company. If you put a gun to my head, said, "Charlie, you've got to buy a big technology company," I might choose Google.

They certainly hire brains. They're getting the best brains, I think, of anybody. They're certainly fanatic. They certainly have an entrenched position. Do I understand the value of their moat compared to the value of everybody else's? The answer is no. You're asking the wrong person.

By the way, anybody who does give you the answer is probably full of you know what.

[laughter]

Q: Denmark was recently declared the most happy country in the world. Any thoughts on that?

Mr. Munger: It may be true!

[laughter]

You've got a Nordic nation without a lot of tropical diseases. You've got a big social safety net. It's monoethnic, so they don't have the tensions of different groups making the place hard to govern. They're situated and surrounded by advanced civilizations, so they can live pretty well, whether they invent anything new themselves or not.

It's very favorably located. If you are in a small group with which you closely identify, you don't mind supporting one another more. It's just the way the human mind works. It may well be that if you measure happiness physiologically by time spent smiling, and so forth, then Denmark may well be happier than almost any place else. I suspect it's true. That does not make me want to live in Denmark.

[laughter]

I'll take the world the way it is, where I live. I prefer it.

Q: I'm an engineer. How do we keep engineering undergraduates from running off into finance?

Mr. Munger: The answer to that is, "I don't know." I don't think it's

good having all the brains go into finance. Just like it's not good to have so many gambling casinos in disguise in the financial markets. I don't think that the current development is good. If I were running the world as an omnipotent emperor, I would change the laws, so the outcome changed.

I would change the incentives. The chances of anybody paying attention to my ideas about the laws are zero.

Q: At the Westco meeting about twenty years ago, you were asked the question, "What do you consider the most important invention of the twentieth century?" You said, "Air conditioning." You then talked about huge swathes of the United States that really were tropics before air conditioning. What would you say today has been the most significant invention of the last hundred years?

Mr. Munger: It's hard not to say the Internet. We had the good transportation, the airplanes, the trains, the air conditioning, the good pharmaceuticals and so on. Having the Internet, the instant cellphone, the little portable computers, the iPads and so on, that's what made this one woman in China who didn't have any power before change a whole governmental outcome. It's having other dramatic changes, including destructive changes on investments. I would say the Internet is very important. Don't you think everybody feels that way?

Q: Berkshire has put a lot of money behind MidAmerican Energy. How do you see that playing out?

Mr. Munger: Very well.

[laughter]

I think it will work out very well. Again, we're trying to do the right thing by the regulators, the customers, the engineering, the safety, you name it. I think it'll work very well for Berkshire. I think it will work very well for the customers of MidAmerican Energy.

I wish I was that optimistic about everything, as I am about that one. I

regard that as almost a no-brainer.

Q: What separated Teledyne's Henry Singleton from the other people who developed conglomerates, and why did you and Warren respect him?

Mr. Munger: We respect Henry Singleton for a very simple reason: He was a genius. Henry Singleton never took an aptitude test where he didn't score an 800 and leave early.

[laughter]

He was a major mathematical genius, a Putman Fellow. Even when he was an old man, he could play chess blindfolded, at just below the Grand Master level. He had an awesome intellect, well into the top 1/1,000 of one percent.

This was an extreme analytic. Of course, he did create a conglomerate because it was legally allowed at the time. He did it the way everybody else was doing it, he did it better, and he made a lot of money. When they ran out of favor, the stock went way down, he bought it all back for less than it was worth.

Of course, he died a very wealthy man. He was a totally rational human being in things like finance. What I found interesting about Henry Singleton, which has interesting educational implications, is that in watching both Henry and Warren invest and operate at the same time, we had two great windows of opportunity to examine human nature.

Henry was very rational. He was quite similar to Berkshire in some ways. Henry never issued a stock option. He had certain commonalities with Warren that were just logical outcomes.

What was interesting to me was how much smarter Warren was at investing money than Henry. Henry was born a lot smarter, but Warren had thought about investments a lot longer. Warren just ran rings around Henry as an investor even though Henry was a genius, and Warren was a

mere almost-genius.

[laughter]

That is my last question because we reached the time when the directors meet, and besides, even for a group of addicts, you've probably had all you can take.

[applause]

Charlie Discussing Daily Journal's Business:

So we had this newspaper which formally had monopolistic qualities, and like many newspapers, it was a fine business. It required some management, but it was fool proof. And of course the world changed for us, as for other newspapers. A million a year pre-taxes is what we have left. In other words, whether we'll keep going down or hold there I don't know. But if you're holding this stock because you want that newspaper to come back to its former glory, I've suspect you've developed some sort of different rational.

What we did as we were in the same position as other newspapers were in where they were shrinking towards oblivion, was we made a lot of money out of the foreclosure boom. We had more than 80% of the foreclosure notice business, and **it was like being an undertaker in a plague year.** It provided huge prosperity for us, coming at a time when everyone else was in total agony. Well that gave us a lot of money and we used that money to buy securities at low prices during the panic.

Aided by that peculiar response to the deterioration of our newspaper business we have entered the software business. And that has been a slow expensive troublesome thing. Now we have written off practically everything we spent on it. And we had plenty of taxable income to do that with. What's happened now is that we now have more software revenues than we have print revenues. And that business is way better. Now it's not doing better in terms of reported earnings, but on the sales field, we're just keep doing better and better and better because our product, we honestly believe, is way better than our main competitors. And there's a endless market for software in these (publications). District Attorneys, Adoption Agencies, Courts, etc. You could hardly imagine anything more sure to keep flourishing and to keep needing more and better software systems.

Now it's agony to do business with a whole bunch of public bodies and their consultants and their bureaucracies and so on. And it's such agony that a lot of big companies that are in software don't come near it. If you're Microsoft, you're use to easy money. And this just looks like agony. The really big boys find our niche in the software market such absolute agony that they tend to stay out of it. And I think our products are probably better than those of our main opposition. But of course our opposition has way more of the market.

What you people have now is a sort of venture capital operation in the software business with the (tag-end) remnants of a newspaper attached. And the stock may be reasonable if you like highly valued venture capital investments, but for you old time Ben Graham groupies, you're in a new territory. I'm not saying it won't work, but if it works, you don't really deserve it.

Charlie Begins Taking Questions:

Question: Could you tell us one or two opportunities that you're excited about for journal technologies? And also, in the next year, what are one or two hurdles or threats?

Answer: The one that I'm most excited about, in Daily Journal technologies, was getting the contract from the Los Angeles courts. It's one of the biggest court systems on earth and that was, as far as I was concerned, a crucial milestone. And you can stop and think about it. If we succeed in saturating California, with a huge success, it may well spread

elsewhere. And we bought this little nothing of a software company…and it turns out that they're really good at all this service to all of these clients that need to have the service.

We've crossed over into a new business. And the new business is interesting because it's a big market. It's a big market. And I think if you ever get entrenched in it, it will be a very sticky business. Which has occurred to us as we suffered all of this agony. At least we were suffering agony in an attempt to get into a position from which we'd be hard to dislodge.

And the main threat or hurdle is that we want to be the most important player in this new niche, which is a big, big, niche. And of course we're concerned about that. I don't regard that battle as won. I regard it as going well, but not won. In fact I'd even say going very well, but not won.

Question: In investing, you talk about how you want to stay in your circle of competence. A few years ago, Warren Buffett decided to buy IBM. And he's still very optimistic. But some people say that he went out of his circle of competence. What is your comment about this investment, and what do you think of its future?

Answer: Well IBM was a lot like us, they had a traditional business that was very large and it was very sticky. And of course, the world changed, and a lot of what flourished in the new world, they were not the leader. Up came Oracle and Microsoft and all kinds of other people who were formerly not so large. And of course they didn't do well in personal computers even though they well started it.

IBM is a position that is lot like us where they have an old business from which cash continues to flow, but they want a new product that's a hit. Now the product that they've chosen to back is this…I call it an "automated checklist". Well an automated checklist is a very good idea and it may be particularly useful in things like medicine, but is it the kind of super market that may replace a lot of what made IBM great? And I would say the jury is out on that. I don't really have an opinion. In other words, I'm neither a believer or a disbeliever, I regard it as a mystery. It could happen and it could not happen as far as I'm concerned. I do think that the old business of IBM is very sticky and will die slowly.

It's not a cinch. The truth of the matter is that at Berkshire's size, where we have to make great big bets and hold them for long periods, that's a tough game and we have to make

bets that are not the kind of shooting fish in a barrel kind of bets that we use to make. And that's one of them.

So…the answer my friend is blowing in the wind. It may work in a mediocre way, it may work big, I just don't know.

Question: What advice do you give to your grandchildren?

Answer: Well regarding the grandchildren, I was not able to change my children very much. My situation reminds me what Clarence Darrow said when he read the great poem that ended, "I am the master of my fate, I am the captain of my soul." Clarence Darrow said, "Master of my fate? Hell, I don't even pull an oar!" That's the way I feel about changing the children. And regarding the grandchildren, thank God they're somebody else's problem. (Big laughter) I served my time.

Question: Do you have a favorite investment story?

Answer: Well, investment stories from my younger days…I'll tell a story I've never told before. Years ago, 1962, my friend Al Marshall came to me and said, "I want your help in bidding for some oil royalties." They were being put up by auction. I soon realized that under the peculiar rules of an idiot civilization, the only people who were going to bid for these oil royalties were oil royalty brokers who were scroungy, dishonorable, cheap bunch of bastards. I realized that none of them would ever bid a fair price. So I said, "We just need to bid high enough to get some of these royalties. You can't possibly fail in an auction where they excluded everybody but kind of shady, difficult, cheap bastards." So we bid for those oil royalties and we financed the thing with a down payment. We each put up a thousand dollars, and for many, many, years, the Mungers were getting $100,000 a year, 50 years later. More than 50 years later. Out of a thousand dollar investment. The problem with that story is that it only happened once. (Laughter) That's true with most good investment stories. You don't get very many. It isn't like that kind of opportunity comes along every day. The trick in life is when you get the one, or two, or three that your fair allotment for a life is that you've got to do something about it. So that's my story from my youthful days.

Question: How is the current energy environment compared to the early 80's when you were running Wesco are there any notable similarities or differences this time around?

Answer: Well of course we owned Wesco for a long time. What's interesting about both Blue Chimp Stamps, which controlled Wesco, and Wesco is that they eventually were some of the most successful investments in the history of mankind. What's interest about those outcomes is that it was only 5 or 6 transactions that carried all the freight. Really heavy freight. Now that is really interesting when you stop and think about it. You try and do a zillion little acquisitions…it's hard. But by just doing a few things over a long period of time and having them work out well, those little nothing companies… They were all doomed. The trading stamp business. The savings and loan association. The savings and loans are pretty long gone. And yet they worked out fairly well. There again, just a few good decisions over a long period of time.

Some great investment success once said, "You make your money by the waiting." Now that doesn't mean sitting around for the next depression, you can't do that, but a fair amount of patience is required in some of these good investment records. Patience followed by pretty aggressive conduct when the time comes. Imagine sitting there, were having all of this money rolling in with the foreclosure boom, and then deploying it in like one day. At the bottom tick for some of those stocks. Now that was luck. And it was luck that we had caught the bottom tick. It wasn't luck that we had the money on hand when other people didn't and were willing to deploy it when other people were running for cover.

Question: What other business models did Berkshire Hathaway try/consider, but ultimately did not pursue?

Answer: Well we were always optimistic. We wanted to buy the best thing that was conveniently available and that we could understand. In the early days, we thought we had a special advantage as investors in our little securities, so we tended to look carefully at float businesses. Nowadays of course, we've got enormous float and it hasn't been that much use to us. Such is the nature of life. We made so much money on those float businesses that it was obscene in the early days. And it's not a tragedy that now our float businesses don't get much advantage about the float. Berkshire's cash which is large is not getting much of a return. In Europe, the rates are negative. Japan the rates are negative.

Question: What do you think about the attractiveness of the software business versus industrial franchises?

Answer: Software based businesses, some of them have become some of the most profitable businesses on earth. Other software companies are failing and shrinking. So it's like the rest of capitalism. It has its good spots and its bad spots. And as I've said, the one we're pursuing will be sticky if we succeed in it.

Question: Other competing businesses in the journal tech space are growing faster. Why is that? And they seem to be selling for higher multiples. Would you ever consider selling Daily Journal Technologies at a high multiple?

Answer: Well, nobody has offered us a high multiple. It's a peculiar part of the software business involving a lot of agony now for a payoff way later. You can't judge it as a normal business. It's venture capital. It just happens to be located in a publicly traded company. If venture capital works, it could gradually evolve into a pretty huge business. But of course, everybody's trying to evolve into a pretty huge business, and only a few succeed. But we're not like a normal software business. And those little companies were not acquisitions like Berkshire Hathaway makes acquisitions, those were not established companies that were sure to succeed and relatively fool proof. If we were going to make our venture capital type assault on this kind of peculiar part of the software market, we needed momentum from other sales forces and service operations and so forth. So we just bought them. But don't judge those things by the standards of normal corporate acquisitions. Those are part of venture capital.

Question: If you were to design CEO compensation for an insurance company or bank, how would you do that?

Answer: Well both Berkshire and the Daily Journal have our own way of doing things and we don't follow anybody else's. We just try to do whatever makes sense under the circumstances.

Question: What's your expectations about BYD for the next 10 years?

Answer: Well, we allow questions on all subjects, and I suppose that one is a legitimate question. BYD has 220,000 employees. That is a big company. That too was venture capital when we went into it. That company has done amazing things. The man who created that company was like the eighth son of a peasant. He went to engineering school, got a PHD, and started off by borrowing $300,000 from the Bank of China. And

going into the small batteries for cell phones and so forth which was totally dominated by high-tech Japanese firms. And he succeed in grabbing about a third of that market from a standing start of zero. And he won the intellectual property rights of the litigation. And that litigation happened in Japan. He was a very remarkable man doing an almost insanely ambitious thing. And out of that, he has 200 and some thousand employees and a huge lithium battery plant. Last month he sold 10,000 electric cars in China which is more than Tesla sold. And of course nobody's hardly heard of BYD.

It's an interesting company. Berkshire doesn't do this kind of venture Capital stuff. And I hope the Daily Journal will work out half as well as I expect BYD to work out.

BYD is in a position, on purpose, to benefit from this electrification trend in the world. **It's been very helpful to them that people are dying on the streets of Beijing because they can't breathe the air.** They haveto go to electric cars in Beijing. And BYD is ahead in terms of efficient manufacturing.

They're very well located. That's a very interesting venture capital investment. Now was it an accident? Sort of. Berkshire departed from its standard methods and did that one. I would say that I only wish our prospects were as good as BYD's. And by the way, they might be, but it's not the way to bet.

Question: When you value a company, what discount rate should we use? Warren Buffett has used a risk free rate and sometimes makes some adjustments. And I've read that you use an opportunity cost approach of your next best investment. Which one of these are correct?

Answer: Well, they're both correct. Obviously it's relevant what the return you get on a government bonds is. That affects the value of other assets (in the general climate). And obviously your opportunity cost should govern your own investment decision making. If you happen to have rich Uncle who will sell you a business for 10% of what it is worth, you don't want to think about some other investment. Your opportunity cost is so great that you forget about everything else. And most people don't pay enough attention to opportunity costs.

Bridge players know about opportunity costs. Poker players know about opportunity costs.

Question: When you arrive at the valuation number using the discount rate, does that mean that between the two rates…

Answer: We don't use numeric formulas that way. We take into account a whole lot of factors. It's a multifactor thing and there's a trade-off between factors, and it's just like a bridge hand. You have to think of a lot of different things at once. **There's never going to be a formula that will make you rich just by going through some numerical process.** If that were true, every mathematical nerd that gets A's in algebra would be rich. (laughter) That's not the way it works.

You've got to be comfortable thinking about a lot of different things at once, and correctly thinking about a lot of different things at once. You don't have a formula that will help you… and all that stuff is relevant. Opportunity cost of course is crucial. And of course the risk free rate is part of a factor that determines how attractive some common stock is.

Question: Do you use the same discount rate for different businesses. For example, an IBM or a Coca-Cola?

The answer is, no, of course not. Different businesses get different treatments. They all are viewed in terms of value and you weigh one against another. But of course we'll pay more for a good business than a lousy one.

We don't really want any lousy businesses anymore. We use to make money by (buying) lousy businesses and kind of wringing money out of them. That is a painful difficult way to make money if you're already rich. (laughter) We don't do much of it any more. Sometimes we do it by accident because one of our businesses turns (on us)… and we deal with those businesses the best we can, but we're not looking for new ones.

Question: I have a mental models question for you. You talk about these quick, cut to the chase, algorithms that you use, do you arrive at that fluency only after having gone through your entire mental model checklist over a long period of time? Or is it simply a matter of, for example, knowing you're looking at a social situation and so the psychology checklist might be appropriate.

Answer: Well, if you're talking about multiple models, that means you're thinking about

many different models. That's the nature of reality particularly if your an investor with a wide variety of human activities, and there's no way to make that easy.

Look, you all are in the business, do you find it easy? (laughter) Anybody who finds it easy is wrong. You're living in a delusion. It's not easy. You occasionally will get an easy one. But not very many. Mostly it's hard.

How many people find it hard to make those investments right now? (Most people raise their hands) Yeah, yeah, it's an intelligent group of people. (laughter) We collect them.

Question: You talk about making an effort to reduce standard errors and doing so by not taking part in auction processes. In terms of your daily habits or life habits, what you do that most people don't, to reduce standard errors.

Answer: Well, there are two things Warren and I have done, and Rick Guerin has done too. One is that we spend a lot of time thinking. Our schedules are not that crowded. And we're constantly…**We look like academics more than we do like businessmen.** So our system has been to sift life for a few opportunities and seize a few of them. And we don't mind long periods in which nothing happens.

And Warren is exactly the same way. Warren's sitting on top of an empire, and you go to his schedule sometimes and there's a haircut! (laughter) "Oh, there's a haircut today." That's what created one of the most successful business records in history. He has a lot of time to think.

And that brings me to the subject of multi-tasking. All of you people have got very good at multi-tasking, and that would be fine if you were the chief nurse in a hospital, but as an investor, I think you're on the wrong road. Multi-tasking will not give you the highest quality of thought that man is capable of doing. Juggling two or three balls at once where people come at you on their schedule, not yours, is not an ideal thinking environment.

But I do think that the constant search for wisdom, and the constant search for the right kind of temperamental reaction towards opportunity, I think that will never be obsolete. And you can apply that to your personal life too. Most of you are not going to get five opportunities to marry some wonderful person. Heck, most of you aren't going to get one. (laughter) You're just going to have to make do with an ordinary result.

Question: Question regarding Daily Journal and its purchase of Wells Fargo stock. Wells Fargo was a levered institution and you bought it at a time when banks were failing. How did you arrive at that decision?

Answer: Well that's a good question. I'll take you back to one time before. When Berkshire bought Wells Fargo, the world was coming unglued in banking panic, and again real estate lending had been the source of it. And Wells Fargo had been huge in real estate lending… But the answer was, we knew that the lending officers at Wells Fargo were not normal bank lending officers. They had come up, a lot of them, from the garment district, and they had this cynical view of human life. They were appropriate careful. And when they needed to intervene strongly they did so because they learned that was the right way to run a garment lending business. And they were just better. And so we knew they weren't going to lose as much money as everybody thought they were with that big real estate portfolio. Because they had chosen it better and they had managed it better, etc. etc. So we had an information advantage just based on general thinking and collecting data…We were aware that they had that special capacity. Well that gave us a big advantage so we bought heavily. That was one.

Now number two; the Daily Journal Company. When the world was coming unglued when the Daily Journal bought Wells Fargo stock. But we again, we knew that the bankers at Wells Fargo were more rational than ordinary bankers. It was a different kind of superiority and rationality. It wasn't this big real estate portfolio on a shrewd way of handling developers. But it was still a shrewder way of being in banking.

I don't think anybody could ever buy a bank who doesn't having a feeling for how really shrewd the management is. Banking is a field where it's easy to delude yourself into reporting big numbers that aren't really being earned. It's a very dangerous place for an investor. Without deep insight into banking, you should (avoid it).

Question: Two powerful mental models are the concept of specialization, and the multi-disciplinary approach. Do you have any advice on synthesizing them?

Answer: Saying you're in favor of synthesis is like saying you're in favor of reality. Synthesis is reality because we live in a world with multiple factors and models. And of course you've got to have synthesis to understand a situation when two factors are intertwined. So of course you want to be good at synthesis. And it's easy to say that you

want to be good at synthesis, but it's not what the reward system of the world pays for. They want extreme specialization. And by the way, for most people, extreme specialization is the way to succeed. Most people are way better off being a chiropodist than trying to understand a little bit of all the disciplines. I don't want a chiropodist who's trying to be a poet. I want somebody who really knows a lot about feet. And the rest of the world is that way. And so this model of being good at synthesis across a lot of disciplines it's very helpful to some people. But it's not the correct career advice for most people. For most people the correct career advice is figure out some clever specialty and get very, very good at it. The trouble of it is, is if that's all you do, you make terrible mistakes everywhere else.

So synthesis should be your second attack on the world. And it's really**defensive**. Without synthesis, you'll be blindsided in all the other parts of your life that aren't "chiropity".

Question: What advice could you give for a person to improve their own rationality.

Answer: Well start working at it young and keep doing it until you're as old as I am. That's a very good idea, and it's a lot of fun. Particularly if you're good at it. I can hardly think of anything that's more fun.

You don't have to be the Emperor of Japan to get fun out of rationality. If you can avoid a lot of hopeless messes and you can help other people (avoid) a lot of their messes, you can be a very constructive citizen. If you're always rational.

Being rational means that you avoid certain things, it's like "I don't want to go where I'm going to die." I don't want to go where the standard result is awful. Where is the standard result awful? Try anger. Try resentment. Try jealousy. Envy. All of these things are just one way tickets to hell. And yet some people just wallow in them. And of course, it's a total disaster for them and everybody around them.

Another one that is just awful is self-pity. If you're dying of cancer, don't feel sorry for yourself. Just chin up, and suck it up. Self-pity is not going to improve anything, including (cancer). Self pity is just…forget about it. Get it out of your repertoire.

Question: Some people have not found the ROI on marriage to be worth it. What's your

valuation on the investment of marriage.

Answer: Well, I think different folks can live in different ways, but I think all the evidence is that marriage is the best practical alternative for most people. And the statistics show it. They live longer. When you measure happiness, physiologically and so forth. Considering how difficult the world is, it's your best chance for most people. And of course it should be valued.

That's one of the things I like about the Asian cultures. The Confusion idea that the family is really important. It's a very sound idea. If we ever lost the family values, we'd have one hell of a lousy civilization.

Question: Happy belated 29th birthday.

Answer: Yes. Very belated.

Question: Why purchase real estate in Utah, rather than deploying it in the technology business?

Answer: We think we're going to be in Logan, Utah for a long time. We have a very happy bunch of employees there. They like their work, they like their community, they like everything about it. And it's part of a business operation. We've got customers who come there and it's a very presentable building. I've never seen it, but it's got a river that flows by. Of course we're glad to own it. We own this real estate. We bought it cheaply, we built it cheaply, it's a nice piece of property. The neighborhood around it has steadily upgraded and gentrified it as we expected. Nothing wrong with owning a little real estate. Our way of getting ahead was not to be real estate operators. But we don't mind owning real estate, it's part of the business. **And it simplifies life.**

Question: Do you think a person who can't make money running a New Jersey casino is qualified to be President of the United States?

Answer: Well, he did make money for quite a while. My attitude is that anybody who makes his living running a casino is not morally qualified to be President of the United States. I regard it as a very dirty way to make money.

Question: What has given you the greatest sense of accomplishment?

Answer: Well, my family life has been more important to me than wealth or prominence. On the other hand, I hated poverty and obscurity. (laughter) I tried to get out of them and it has given me some satisfaction that I came a long way from where I've started. I think most people who've come a long way from where they've started feel pretty good about it. I think most the people who've finally sat atop of Everest, even though they'll only stay there for 15 seconds… And so, I think that's good. Cicero use to say that 'one way to be happy in old age is to remember a lot of achievements in your past.' Now some people say that's too damn self-centered and you should be thinking about God or something, but I agree with Cicero. It's ok to live that kind of a life if you're kind of pleased with it when you're old and look back.

Question: If you had any advice to give to a younger version of yourself, what would it be?

Answer: Well my advice is always so trite. The good behavior, being dependable, and morality. It makes your life easier. It makes it work better. You don't have to remember your lies which gets complicated if you keep lying all of the time. In fact, it gets so complicated that you're sure to fall off and you'll be recognized as a liar. So, I think all the old fashioned morality works. The old fashioned discipline works. The old fashioned good behavior and a little generosity.

We all know people who have people come to their funeral just to make sure they're dead. (laughter) You don't want to be in that crowd. You want to live your life so that some people will actually miss you when you're gone.

I think Kiplings's 'if', is a great poetry. Kiplings doesn't exist in the modern college anymore. It wasn't politically correct. So I think Kiplings's "if" is great poetry and it's great advice. "If you can keep your head when all about you are losing theirs". What's wrong with that? And the quote, "Be a Man my son!" Why don't you want to be a man? You want to be some idiot child all your life? Some angry twit? There's so many of them already. There's so much to be gained by never being an angry twit. In fact I think anger is just…If you want to be philosophical, this political situation we all face now, of course it's disgraceful, a lot of these people. I mean, it's bad that a leading civilization has candidates for a high office many of them like those we were talking about. And they're

not all in one party. You don't want to get angry. After all, politicians have been politicians for a long, long, time. And, you want to operate constructively? Vote constructively.

Anger. There's so much anger in politics right now. So much automatic hatred. How could any of us really know whether the United States will be better 50 years from now because we vote Republican or vote Democrat in the next election? Who can tell what the exact mix is between compassion and something else?

All of those things were in the old behavior rules. By the way, the Muslim behavior rules read a lot like the Old Testament. Which of course they copied. They claim they came directly from God, but really they stole them from the Jews.

Question: What is the relationship between oil prices and economic growth?

Answer: I think it's obvious that if oil had been a little cheaper and easier, the growth would have been greater than mankind had. In that sense, if oil gets very expensive and we still need it desperately, it will make life harder, and so there is that correlation between oil prices and economic growth.

On the other hand, some very peculiar things happen. When you take Exxon and Chevron and so forth. What's happened to make those things good investments over the long term, is the damn price of oil went up faster than their production went down. **Now name me another business where you get richer and richer where your production of real units, keep going down, down, down.** So, not everybody would have predicted that in advance including most of the economists. It's a complicated subject…

And there's another trick to it. People who really have a lot of free energy, like the people of the middle east? They have very dysfunctional economies. They're (like) a bunch of rich people spending their capital and not knowing how to do anything that anybody else wants to buy. Maybe in that sense, having a tougher hand has been good for us.

My answer to your question reminds me of what my old Harvard Law professor who use to say to me, "Charlie, let me know what your problem is and I'll try and make it harder for you." I'm afraid that's what I've done for you.

Question: How do you understand a new business or new industry that you are trying to

get into where the dynamics are different? How do you get deep insights into the specific domain?

Answer: The answer is barely. I just barely have enough cognitive ability to do what I do. And that's because the world promoted me to the place where I'm stressed. And if you're lucky, that will happen to you. **That's where you want to end up is stressed. You want to have your full powers called for.** And believe you me, I've had that happen to me all my life. I've just barely been able to think through the right answer time after time after time. And sometimes I've failed.

Question: Last year, you had some very pointed comments concerning Valeant, and I want to know, do you have…

Answer: It's caused me nothing but trouble. (laughter)

Question: Do you have any update regarding Valeant? Do you have any areas where you have similar concerns?

Answer: It probably wasn't wise for me to inject myself, I have no dog in that hunt. I have no interest in the pharmaceutical business. I have no interest in Valeant. It's just that you people have come so far…(laughter)…to tell you amusing stories about life and make comments about current affairs. And Valeant was such an extreme example of misbehavior.

It ended up with one of the Valeant shareholders saying that Warren Buffett was a sinner because he owned Coca-Cola. I drew retaliation to Warren. By the way, that's a good place, if you're anybody that's mad at me today, why (not get) mad at Warren? He can handle it, he's a very philosophical man.

It is true that these crazy false values, and these crazy excess, is, it's bad morals and it's bad policy. It's bad for the Nation. It's just bad, bad, bad. And there's a lot of it. And of course there's a lot of it is in American Finance… The truth of the matter is that Elizabeth Warren would not agree with me on many subjects and I wouldn't agree with her on many subjects, but she is basically right when she says that American finance is out of control and has too much evil and folly. And it isn't good for the rest of us. Both Elizabeth Warren and Bernie Sanders, not two of my favorite people on earth, are absolutely right

on that subject. And the extent that you all see it. You all see what all goes on in finance with the craziness…It's very bad for all of us that we have this huge overdevelopment of finance. And yet, it's pretty hard to do anything about it.

What happened was, you look back to say Edwardian England, or a little before. And maybe 300 people owned half the land in England and they had nothing to do. What did they do? They went into the clubs of London and they sat around the card tables and they played (card games) for high stakes. And that's what human nature does when people have a lot of leisure and so on.

Fade in, fade out, and multiply the wealth per capita of the world by 30 or so and now we got all kinds of people who are like the Lords of England who had all that time to sit around and play cards against one another and enjoy thrills and games of gambling.

We have a vast gambling culture and people have made it respectable. Instead of betting on horses or prize fights, they bet on the price of securities, or the price of derivates relating to securities. Of course you can bet on athletic contests. We have a huge amount of legalized gambling. And of course the public market that operates every day with transactions is an ideal casino. And there's a whole bunch of people who want to own the casino and make a lot of money without losing money on inventories or credit risks, or any other irritating parts of business. Just to sit there and have every night gold go higher and higher. Who doesn't want to be croupier at a casino? And very respectable people get drawn into it if they see other people getting rich at it. There's way too much of that in America. And too much of the new wealth has gone to people who either own the casino or they're good at playing others in the casino. And I don't think the exhalation of that group has been good for (the public generally).

And I am to some extent a member of that group… and I'm always afraid that I'll be a terrible example for the youth that I think will just want to make a lot of money with soft white hands and not do much for anybody else, I just wanted to be shrewd in buying little pieces of paper. Even if you do that honestly, I don't consider it very much of a life. Just being shrewd about buying little pieces of paper, shrewder than other people, is not an adequate life. It's not a good example to other people. And it's the reason that people like Warren and me (are charitable and are) running businesses. We're not just buying little pieces of paper.

So I think that we have something going in our nation that is really very serious and very bad. And I hate to agree with Elizabeth Warren on this subject, but she's right. I don't see a way of stopping it except with some big legislation changes.

And you'll say, "What difference does it make?" Well, what happens is, as the cyclicality of the gambling with securities and other assets goes on, what happens is, **the big busts hurt us more than the big booms help us**. And we say that when the great depression ended and the rise of Adolf Hitler. A lot of people think that Hitler rose because of the great Weimar inflation. But you know Germany recovered pretty well from Weimar inflation. What they did is they destroyed the currency. They just issued a new currency. It's really interesting. They said, ('oh people who got rid of their old mortgages we'll replace them with new mortgages and they'll owe us the new currency back.') But what really enabled Hitler to rise was the Great Depression. You put it on top of the Weimar inflation the Great Depression and the people were just so demoralized that they were subject to being snookered by a guttersnipe like Adolf Hitler. So I think this stuff is deadly serious in that these crazy booms should be (nipped in the bud)… People like Alan Greenspan, he's an amiable man but he was an idiot! (laughter)

You do not make the head of the Federal Reserve, the governor of all banking, somebody whose hero is Ayn Rand! Who believed in no government at all! It's a very unlikely place to look for correct decision making. And it's probably not the kind of decision making that we observe. I think he's an honest and amiable man, but of course he didn't see reality the way that it was. A lot of people think that if an ax murder happens in the free market that it has to be all right because free markets are all right. A lot of those people are in my party by the way.

Question: Is the Automobile Industry meaningfully different today than it was (10) years ago? Does GM make sense in the Berkshire portfolio?

Answer: The second one is easy. General Motors is in our Berkshire portfolio because one of our young men likes it. And Warren lets the young men do as they please. Warren, when he was a young man, didn't want any old man telling him what to do. So he delivers that kind of freedom to his young men.

I haven't got the faintest idea of why that young man likes GM. It is true that it's statistically cheap and it may be affected by the federal government in the end. So it may

be a very good investment. But the auto industry is about as brutally competitive an industry now as I have ever seen it. Everybody knows how to make good cars. Everybody. And they rely on the same suppliers. And the cars last a long time with very little service. And everybody leases them at cheap rents, and has all kind of incentives. It has all of the earmarks of a very commoditized, difficult, super competitive market. So I don't think the auto industry is going to be a terribly easy place. And it may actually shrink one of these days. In other words, the culture of everybody having three or four cars could actually shrink. And so, I think that the auto industry is not a cinch. If I were investing in the auto industry, I'd want some place that I thought was way the hell better competitor than the others, and that's hard to find.

Question: For most of the oil market's history there's been some entity enforcing production controls. But today Saudi Arabia (operates) more as a base load producer than controlling OPEC's production. Would you suspect that this will result in protracted negative impact on the economics of all those related to oil production? Or is the way to bet that some entity will eventually re-emerge for production control.

Answer: I would not have predicted that oil would be at its present price. In fact, if you forced me to bet, I would have bet that what has happened wouldn't have happened. But it did. I think that it's generally true that with these commodities you can get periods of extreme high prices, like we had in iron ore, and extreme low prices, like we now have with iron ore. So I think that commodities do strange things both up and down in terms of prices. And of course they have macroeconomic consequences. And huge consequences if you're in Australia having these commodities going way down is terrible. If you're in the tar sands area of Canada having oil prices go down to where they are now…I don't even know how economic it is to produce tar sands oil at $30 per barrel. My guess is that it's not very attractive. And it may not work at all. You're in a weird period.

But I think it's the nature of the human condition that with free markets in stuff like iron ore and oil, you're going to have weird periods high prices and weird periods of low prices**. I've never been able to predict accurately, or make money predicting accurately those swings. We've tended to get into good businesses and then take the bumps as they fall.**

Question: Would you please recommend some books that you've enjoyed lately?

Answer: Well you people send me books, like 30 a week. That I tend to skim them so rapidly that I no longer develop the joy of reading I use to when I picked a few books of my own to read. (laughter) So you're ruining my judgment of books. I can't resist reading the damn things when you send them to me. No I skim a lot of them, and I like each one in its way, because it's different from anything else I normally do. But I'm no longer a good book source.

Question: Regarding philanthropic work, what inspired you and what results do you look for?

Answer: Well, I never wanted to tackle problems like world peace. I read enough biographies. Carnegi thought he was so smart and so rich, so he thought that he'd use his money to create world peace…I watched Carnegie try to do it and I decided that if he couldn't do it, then I'm going to leave it alone. So I don't take up those big subjects.

I like to create dormitories, science teaching facilities, stuff like that. It's a pretty modest activity, but it's interesting to me, and it's easy to do them better than most people do them. I have no feeling that I have any advantage about bringing about world peace, but I am pretty good at dormitories. So I do what I'm good at, and I suggest that all of you do the same thing.

Question:

Mr. Buffett has stated that he believes that income inequality is an issue that needs to be addressed. With Senator Sanders, he has built his campaign around this issues. And with so many from my generation starting to "feel the Bern", how would you address this issue?

Answer:

Well, that's a very good question because it's…we've had Piketty and then Sanders. My attitude is that both Sanders and Piketty are a little nuts. People who really were passionate about egality and wanted to bring it about by government action, gave us things like the Soviet Union, with all the death and agony and the poverty they have now in spite of (having egality). And Communist China, they got egality, and think of the unnecessary deaths. North Korea?

I'm suspicious for all of this passion for egality that has such bad examples. On the other hand, if you want to look at what non-egality brings us. Let's just take Communist China. Communist China had egality, meaning that three fourths of their people were dirt poor, subsistence level poor. But they had the advantage of being equal. They were all struggling to get enough to eat. And of course when they adopted private property and more property rights, and so on, what they got was living standards that had advanced by a factor of 10 or so more quickly than anyone ever had. But of course they had a lot more inequality. You have all of these rich Chinese. I think it's been a very good bargain for the Chinese to have.

In other words, I don't think Bernie Sanders understands this at all. He doesn't want to understand it. He has a religion. He's had it for 30 years. He's a Johnny one note. It doesn't matter. As an intellectual he's a disgrace. I think that we'd all be glad to have him marry into the family, but as a thinker he's…pretty bad. Now I don't think he's any worse than some of our Republicans, but at least they're crazy in a different way.

But the egality has one effect in a democracy, which Aristotle comments on, people will cheerfully tolerate considerable differences of outcome if they seem deserved. Nobody minds the fact that Tiger Woods has a big income because he's the best golfer who's ever lived. Or you find somebody who invents something wonderful, or a surgeon who's way better than other surgeons, etc , etc. But differences in outcomes that are perceived as undeserved tend to disrupt democracy. That's why Aristotle commented on it in one of his most well known observations.

And of course who is getting the undeserved money in America now? Good question. It is not Bill Gates, it is not the people who create the new companies… We don't resent their success.

I think we have a lot of underserved wealth that causes a lot of envy. And to some extent, well, I think envy is always a bad idea. I think it's also inevitable that we're going to have a lot of it. There's a lot of undeserved wealth in the financial class. In a lot of cases for doing nothing, or being counterproductive. So I think that fixing the obviously undeserved wealth of a lot of people would be a constructive thing. If you take the ordinary investment partnership, not only do they get capital gains on what for anybody else would be ordinary income, but they don't pay any income tax at all. Because it's unrealized appreciation that gradually shifted to the general partner and he can take securities out when he leaves the

business and not recognize the gain. They have enormous liquid fortunes being made on paying no taxes at all. Naturally that's resented. It would be resented even more if people understood it. But that's not very complicated to understand. And so, I think by and large, feeling unhappy with inequality…Inequality is the natural outcome of a successful civilization that is improving for everybody.

Most of these guys (wealthy individuals) are not that interested in politics. People like to talk about the terrible influence of the rich on politics. But when you're rich, you realize how little influence the rich really have.

I think that these people who are raging about inequality, like Picketty and Sanders are wrong. But I think that the people who say that the undeserved wealth deserves some attention, I think they're right. I think a huge source of the undeserved wealth is coming from the old finance.

Question: You mentioned Wells Fargo earlier and its culture and the reason that you bought it back in the 80's. Daily Journal Corporation owns U.S. Bank as well. You also own Bank of America and its culture is a little different. And I'm curious if the decision to buy Bank of America was driven by its low price or if you also see the compounding element.

Answer: Bank of America was bought through the way that we use to buy securities. It just got pounded so hard that it was selling for less than it was worth. Way less. And there's a lot in the Bank of America which is sound.

Question: I'm pretty excited about the prospect of self-driving cars over the next 10-20 years. It seems like the technology is moving very quickly. As a Berkshire shareholder I'm worried about the implications about the entire auto insurance if accidents, hopefully, become a thing of the past. That's good for civilization, bad for the auto insurance business. I would love to hear your thoughts on that.

Answer: Well you're right. If all the cars run around without drivers, it will be bad for Geico. And I don't think it's going to happen very quickly. In fact I think it's going to be quite slow. But in the auto industry…the first thing that people did when they got new wealth was (buy) more cars. I think that even if we don't get self-driving cars, that culture may be waning. Not so much in the third world, but in places like America.

Question: Could you publish a personal book list of the books in your library?

Answer: I don't want to be a book recommender. (laughter) It would be quite time consuming. So I'm afraid you'll have to (ask another question).

Question: A lot of people here have the ability to do well, but they don't have the opportunity to meet the right people. Ronald Burkle credits you with give him credibility when he was starting to acquire grocery stores at age 30. Who was your mutual acquaintance and how was Ron Burkle able to meet you in the early 1980s.

Answer: In those days, we (Berkshire Hathaway) had a lot of declining businesses and one of them was trading stamps. And our last big trading stamp customer was the company that Ron Burkle's father controlled. And that's where I met Ron Burkle. It was an attempt to preserve that customer. The last customer we had. And in due course I failed. Ron Burkle on the other hand left that occasion and did nothing but succeed. So maybe you should ask him.

Question: What's your view on the Unicorn companies like Airbnb, Uber, etc. Do you think those companies have such high valuations can ever go public?

Answer: Well, my attitude is that I have a circle of competence. And that does not include correctly predicting which new companies in Silicon Valley, or dependent on Silicon Valley, are going to succeed. So I tend to avoid the subject entirely. I've paved my way in other passions. However I will comment on one thing. Manipulated Finance.

As these venture capitalists, who are part of the finance industry, the constructive ones. These are the people who make their living more honorable than the rest of the people in finance because they're actually allocating capital to new businesses. So the venture capitalists are useful members of finance. But they don't escape their share of sin. What they've gotten in the habit of doing is creating these rounds of financing. And each new one is at a higher value. But they just sneak a little clause in saying, that nobody who previously bought into the venture gets anything until the new guys are preferred. Well that is sort of like a ponzi scheme. It's a disgusting, tricky, dishonorable thing to do. Particularly since it's obscured. And of course it's being deliberately obscured.

So even our most reputable part of finance has dirty sleazy activities creeping in. **Large**

amounts of easy money cause regrettable human behavior. That's Munger's rule.

Question: Apparently the environment that we invest in today is very different from when you started. With high frequency trading, momentum trading, and all of that, do you think that fundamental value investing is losing relevance?

Answer: I don't think that fundamental value investing will ever be irrelevant because of course to succeed in investing you have to buy things for less than they're worth instead of more than they're worth. You have to be smarter than the market. That will never go out of style. I mean that is like arithmetic it's always going to be with us.

Now as far as high frequency trading, that is a complicated subject. I think that high frequency traders of the world, many of whom are personally admirably and honorable people, I think they have all made contributions to the American economy like a bunch of rats do in a granary. (laughter) They're just sucking some of the resources out for themselves while contributing nothing to the civilization.

Question: Do you have a specific approach to spending quality time with your family?

Answer: Well, I don't think I want to (promote) myself as some wonderful example of family life. I did the best I could…

Question: Do you think that Coach Nick Saben shares qualities with Sam Walton?

Answer: I don't know anything about Coaching. I'm better at Ballet.

Question: Could you name a few people in history that you admire?

Answer: Well of course there's a lot of historical people that I admire. One of the advantages of being a reader is that you can consort with some of the best people who have ever lived. So that's what I do with a lot of my time. But I admire a lot of people, take surgeons who get way the hell better than other surgeons…or take some actor who gets to be the best actor in the world, and moves and entertains a lot of people. And there are a lot of people who are constructive, intelligence, generous and improve the world for the rest of us. And there are a lot of people who are good examples. And I spent some time, because he was on the Costco board for a long time, with Dan Evans who was

Senator and Governor in the state of Washington. Generally admirable, sensible, high-grade, politician. There's so few politicians like Dan Evans.

But when you do find a Dan Evans you really admire him and like him. And I think there will always be admirable people. That's what we all want to be. We all want to be admirable. **What you want to be is the kind of people, other people name in their will to raise their children if they die unexpectedly.** When a lot of people are doing that, you'll know you're doing something right. **People are very shrewd about guessing who will be good at raising their children.**

Question: When you were an attorney, you sold your most important client an hour a day. And I'm guessing that you spent that time reading and thinking, or did you do some other activity for an hour.

Answer: No, no, that was the most important client, myself, you're right about that. It was reading and thinking. The beauty of doing a lot of reading and thinking is that if you're good at it, you don't have to do much else.

Question: Question about fear. I was once given the advice that it's really important to conquer fear. Could you speak to your relationship with fear and whether you've conquered it.

Answer: Well generally I've avoided circumstances which automatically cause people fear. My son Philip is in the audience. When he was young, he had a saying, he would say, "If at first you don't succeed, well, so much for hang gliding." (laughter) And so I don't seek out fear to get thrills. I don't even seek out the appearance of fear when it's really safe. Generally I'm not a big lover of danger or even the appearance of danger. So that's not my thing. I don't think I've felt much fear for a long time. I've just lived a long time. I had fears when I was younger, but they gradually melted away.

Question: Question about Coke. Sweetened beverages are on the decline. Does Berkshire's ownership give Coke some leeway about addressing the declining nature of their business?

Answer: Well, that's an easy one. Coke for many decades, the basic product, full sugar Coke, grew every year. It was like the inevitable march of time. In recent years, full sugar

coke is declining. Now fortunately the Coca-Cola company has amassed distribution infrastructure business in a lot of other products. Coca-Cola as an individual product is declining some, instead of going up the way it always did before. The rest of the businesses are on average rising. So I think Coke is still a pretty strong company and it will be a respectable investment. **But it's not like it use to be when it was like shooting fish in a barrel.**

I guess that does it.

Transcript of Charlie Munger at the 2017 Daily Journal Corporation Annual Meeting

CHARLIE MUNGER:

The essence of what's going on here, of course, is we have a corporation that was in a branch of the newspaper business, and our branch of the newspaper business, like most newspaper businesses, has gone to hell compared to what it was in its peak years. And almost every other newspaper business is going to hell with no pardon, they're just disappearing. What we have is this computer software business where we're serving the same customers to some extent, except now they're all over the country, even some of them outside the country, with this...we were selling software to all these courts and public agencies, whereas before we were giving information to lawyers and other people and publishing public notices.

And our software business is of a type where it's a long, tough slog, but we're slogging very well and we really love the people who are doing it for us. We've got a lot of wonderful people and in our software business, the implementers and the computer programmers and the people that deal with the public agencies, and the ethos of the place is very admirable. Everybody's trying to get ahead here by doing the work right and serving the customers right and having a lot of financial wherewithal where money is never a problem and doing what we're supposed to do. And so, it's a pleasure to people like Rick Guerin and myself to watch all these young people doing this, and of course we're very glad to be able to do it when we should be dead [laughter].

A lot of you people came into this because Berkshire was successful and Guerin was successful, and for various odd reasons of history, and most of you are accidentally in the software business, and I am too because Guerin did it when I wasn't paying much attention. I don't do this kind of venture capital stuff and he doesn't either, but he did it here, and so if there's anything wrong with what happens in our software business, you're looking at the man who caused it all over here. I'll take credit for the successes, but if there's failure you're looking at the man here who got us into this.

It is amazing to me some of the things that are happening in our software business. We just are getting a contract from South Australia. Now, if anybody told me when I was

young that a Daily Journal company would be automating the courts of South Australia, I mean, I hardly know where it is. Anyway, it's amazing what's happening, and it's a fair amount of fun to watch, probably because we're doing more winning than losing. I've never been able to enjoy losses the way some people do, I would much rather win.

And I really like to work with good people instead of the opposite, and we've got a lot of good employees in our software business. We've got a bunch of implementers in Utah who are really good at it and [who] we really trust, and then the customers like them. We've got all these computer programmers and so forth around here, and a game of service like that when it's complicated, what you have to do is minimize your glitches and crawl out of them very rapidly in a way where the customers trust you, and our people are good at that and they get better and better, and they're trying to get ahead by being good with the service, not by having some politician as a consultant. Some of our competitors do that kind of stuff, but we're trying to slog our way out by doing the work right.

When I was a lawyer, there's a saying I've always used, "The best business-getter any lawyer ever has is the work that's already on his desk." And that's the basic ethos of our software business. If we just keep doing it right I don't think we have to worry about the future, not that we won't have our downdrafts and our failures, but we are actually grinding ahead slowly in that software business.

And it's very interesting because Guerin and I know practically nothing about it, and Gerry didn't come up as a software engineer, so we're basically doing something that's quite difficult. We are judging people because we don't understand what the people do. That's what Andrew Carnegie did, of course, he didn't know anything about making steel, but he knew a lot about judging whether the people he was trusting were good making steel, and of course that's what Berkshire's done if you stop and think about it. We have a lot of businesses at Berkshire that neither Warren nor I could contribute much to, but we're pretty good at judging which people are capable of running those businesses.

But this is pretty extreme here, the little Daily Journal Company going into the computer software business. It's a long, slow kind of business, RFPs. The first time we contact a customer until we started making money, maybe five years, so it's like deciding to start prospecting for oil in Borneo or something, and they just keep doing that over and over again and the money goes out and the effort goes out, and it starts coming in five years from now. I love that kind of stuff, not when I think we're taking territory, it doesn't look good then we write it all off and we don't report wonderful numbers or anything, but if it makes sense in the long term, we just don't give a damn what it looks like over the short term, and we know we've collected a bunch of shareholders that share our ideas. After all, we're running a cult, not a normal company, and I think most of you feel you're willing to wait.

I've lived all my life with people who are into deferred gratification, in fact, most of them will never have any fun, they just defer gratification all the way to the end, that's what we do. It does cause you to get rich, so we're going to have a lot of rich dead people, but we can incite

a lot of envy. A lot of you when the people walk by your grave and there will be this nice grave with this nice monument and they'll say, God, what a great grave, I wish I were under it.

But at any rate, deferred gratification really does work if what you're interested in doing is growing a business that gets better and better or getting rich yourself so that your grave can look nice to outsiders. Guerin and I have never taken any money out of this company in all these years. We don't take salaries, we don't take directors fees. We're a peculiar example. I wish our example spread more because I think if you're wealthy and own a big share of a company and you get to decide what it does and whether it liquidates or whether it keeps going, that's a nice position to be in, and maybe you shouldn't try and grab all the money in addition, and that's my theory on executive compensation.

And some of the old fashioned guys like Carnegie never took a salary to speak of. Cornelius Vanderbilt didn't take any, of course he owned the whole place practically, and he would have considered it beneath him. He lived on the dividends like the shareholders did, and so there's a lot of those old fashioned ideas here in the Daily Journal company.

I'll first take a bunch of questions about the Daily Journal, and after that we'll take questions on anything you want to talk about.

BRAD GILLESPIE:

Hi, Brad Gillespie from Chicago. At least year's meeting you talked about the milestone of getting the LA court system here at Journal Technologies, and I was wondering in the last year as it's gone by, what good milestones have happened and what bad things have happened with that?

CHARLIE MUNGER:

Gerry, you take that one. I'll answer it [in brief]: It's going fine.

GERRY:

We have three case types for Los Angeles. One case type went live last April, another case type will go live this coming July, and the third case type is about 10 to 12 months later after that. We have to work within the Los Angeles schedule. After all, they have a lot of people to train and that becomes a very important factor. Training is critical because if the end users aren't trained properly, virtually everything falls apart, and so that's the schedule. We discussed it this morning, and we meet with the court about three miles from here virtually every day, and we have a good team from the court, and I think they're very excited about what they're doing, and that's critical to us that the court feels good about the system.

CHARLIE MUNGER:

One good thing about what we're doing is it's slow and it's agony in the delays between the first customer contact and finally getting into a decent revenue stream, but once you succeed it's very sticky business, very sticky business, and the fact that it's difficult to do means it's difficult for people to change much, and so if you go slog through all this tough territory [like] we're slogging through there's a reward out there somewhere, and we're not in a small business. It has way more potential than the original print business we had giving information about the appellate cases to lawyers. It's a big market and the people have no option but to charge ahead. These courts and district attorneys, public defenders, all these people that we're serving, they're overwhelmed with options, better systems and more software. So it's a huge market, and the fact that it's so awful to grind through means that the people that want easy gratification don't come in. If it seems slow and painful to you, we kind of like it that way.

MALE SPEAKER:

Another Daily Journal question. I'd be curious on your thoughts about...we're slowly grinding through, but it seems like Tyler Technologies is going to be through a lot quicker, they're just one main, 24 states. So, I was just wondering how you think your competitive position versus Tyler is doing?

CHARLIE MUNGER:

Well, Tyler is an extremely aggressive company and they were bigger faster, and so I liked the ethos of our operation better than I like theirs. If I were buying software, I'd rather buy ours than theirs, so our system is to keep fighting the game, and I wish all the customers I had in life were like Tyler.

GASPAR:

Hi. I'm Gaspar from Marina del Rey. Thanks for your answers so far. I'm a little nervous about the rate of revenue growth going down a little bit, the expenses going up. I appreciate what you're saying about deferred gratification. Any major milestones in the next three to five years that you think you'd like to hit, or any major customers that you'd like to get that would really help things along?

CHARLIE MUNGER:

Well, I'll take the first question. It feels like we're proceeding slowly, but we bought a bunch of contracts in effect for money, and we knew that they were going to end, and so we're amortizing the cost of those contracts. But it was really anticipated at the time that we got big revenues up front for taking, so we're not declining as much as...we're getting ahead. There's a little blip in the figures.

Now, the second part of the question was?

GASPAR:

Any major jumps or acquisitions you'd like to make or customers that you'd like to acquire in the next...

CHARLIE MUNGER:

Every contract that's significant is a major jump, and the business is so big they're whole states. I mean, this is a huge business and everybody is just scrambling at the first parts of something that's going to grow bigger and bigger and last and last, and as long as we're doing the work right, so I'm all right. It's likely to work out right.

MALE SPEAKER:

The Daily Journal owns a lot of Wells Fargo. Can you comment?

CHARLIE MUNGER:

Well, of course Wells Fargo had a glitch. The truth of the matter is they made a business judgment that was wrong. They got so caught up in cross-selling and so forth, having tough incentive systems that they got the incentive systems so aggressive that they, some people reacted badly and did things they shouldn't, and then they used some misjudgment in reacting to the trouble they got in. I don't think anything's fundamentally wrong for the long-pull with Wells Fargo. They made a mistake and it was an easy mistake to make.

The smartest man I ever knew made a similar mistake. Henry Singleton, who was the smartest single human being I knew in my whole life. And Henry Singleton of Teledyne also had very aggressive incentive systems like Wells Fargo and his customers, many of them subsidiaries, was the government and of course it's not that hard to cheat the government. And with his very aggressive incentive systems two to three out of 20 subsidiaries cheated the government, so he's got three scandals at once.

It wasn't that Henry was trying to cheat the government, it's just that he got a little aggressive in applying the incentives and he got blindsided. That can happen to anybody. I don't regard getting the incentives a little aggressive at Wells Fargo as a mistake. I think the mistake there was when the bad news came they didn't recognize it rightly. They made a mistake, but what happens in a tough system like capital, you make a mistake like that and pretty soon you're gone.

RANDY GARDEN:

Randy Garden from Phoenix, Arizona. I'm a Daily Journal shareholder. This is for Gerry or Charlie. Congratulations for inverting and not doing things wrong in regard to Daily Journal. What about, do you have any insight into the Alameda court system and the problems that Tyler's having over there?

CHARLIE MUNGER:

Well, no, but I'm not dissatisfied with it. I don't think I want to criticize Tyler any more than I have. So I think one of our [competitors] you'll be sad to know is having some problems with pleasing a customer. You can see the salt tears running down my cheeks.

MALE SPEAKER:

I have a quick question on your software fees in terms of your revenue lines. What portion of that is recurring versus one-time fees?

CHARLIE MUNGER:

That is so complicated that I'm not even going to try to answer it. I will just answer in substance. There's a lot that's recurring if we stay in there. You can't look at our financial statements and make very good judgments about what's going to happen. It's the nature of our game, but it's confusing. It confuses us a little bit, and so we're not quoting that on purpose. It's a very complex, confusing system when you've got all these RFPs and…it's very complicated.

FEMALE SPEAKER:

Any other questions about the business?

MALE SPEAKER:

So, you purchased the building in Logan, which I believe is used exclusively in Journal Technologies, but in accounting it's under the traditional business, I'm wondering why in the segments.

CHARLIE MUNGER:

Gerry, I give you that one. He says why is Logan somehow in the traditional business? It shouldn't be.

GERRY:

The Daily Journal purchased the building and they own the building, and Journal Technologies pays rent to the parent company for that and the amount of rent is not, what we would consider, material from that perspective, and because it's owned by the Daily Journal that's how we originally classified it, no real significant reasons. Now all the expenses are on the Daily Journal's, or on the General Technologies' books.

CHARLIE MUNGER:

That's some quirk of accounting. It doesn't really matter.

MALE SPEAKER:

I just want to follow up on the question of incentives. You were explaining at Wells Fargo that you might've been a little too aggressive, but you don't have a problem with aggressive incentives. Can you expand on that a little more?

CHARLIE MUNGER:

Well, how do you know that they're aggressive until you try? They didn't react enough to the bad news fast enough, and of course that's a very dangerous thing to do. I don't think it impairs the future of Wells Fargo. As a matter of fact, they'll be better for it. The one nice thing about doing something dumb is you probably won't do it again.

MALE SPEAKER:

So this isn't a Gerry general question, but my question comes from the perspective of someone early in their career who's trying to figure out which of several paths to pursue. Two thoughts that seem helpful for this purpose are 1) figuring out what work you have the possibility of becoming the best at, and 2) ascertaining what kind of work would most help society. Do you think these ideas are the right ones to focus on and if so, how would you go about answering them?

CHARLIE MUNGER:

Well, in terms of picking what to do, I want to report to all of you that in my whole life I've never succeeded much in something I wasn't interested in. So, I don't think you're going to succeed if what you're doing all day doesn't interest you, and you've got to find something you're interested in because it's just too much to expect of human nature that you're going to be very good at something you deeply dislike doing, and so that's one big issue.

And of course you have to play in a game where you've got some unusual talents, even how you play. If you're 5 foot, 1, you don't want to play basketball against a guy that's 8 feet, 3, it's just too hard. And so, you've got to figure out a game where you have an advantage, and it has to be something that you're deeply interested in.

Now you get into the ethical side of life, well, of course you want to be ethical. On the other hand, you can't, you're just dreaming of how you think the world should be run and that it's too dirty for you to get near it. You can get so consumed by some kind of ideological notion, particularly in a left-wing university. It's like you think you're handling ethics, and what you're doing is not working and you're watching a wave go by, and maybe you're smoking a little pot to boot. This is not the Munger system.

My hero is Maimonides, and all that philosophy, and all that writing he did after working 10 or 12 hours a day as a practicing physician all his life. He believed in the engaged life, and so I recommend that you engage life. You spend all your time thinking about

some politician who wants it this way or that way. You're sure you know what's right, you're on the wrong track. You want to do something every day where you're coping with the reality. You want to be more like Maimonides and less like Bernie Sanders.

MALE SPEAKER:

I have a question on American Express. What does increasing the litany of payments weaken as [unintelligible] as a value proposition in the long-rum as in like this American Express value proposition more in terms of payment, or is it more in terms of service and rewards?

CHARLIE MUNGER:

Well, I'm going to give you an answer that will be very helpful to you because you're somewhat confused about what the exact future of American Express will be. I'm confused too. I think that if you think you understand exactly what's going to happen to payment systems 10 years out, you're probably under some state of delusion. It's very hard to know.

So if you're confused, all I can say is welcome to the club. They're doing the best they can, they've got some huge advantages that they're…it's a reasonable bet, but nobody knows. I don't know if IBM is going to sell that much of Watson. I always say I'm agnostic on the subject. You're talking about a payment system 10 years out. I'm agnostic on that too. I think if you keep trying and do the right thing and you play the game hard, your chances are better, but I don't think those things are knowable. Think of how fast they change.

MALE SPEAKER:

Hi, Mr. Munger. Do you think domestic natural gas exploration and production is a good business despite the capital intensity? Thank you.

CHARLIE MUNGER:

Well, that's a different subject. I have a different feeling about the energy business than practically anybody else in America. I wish we weren't producing all this natural gas. I would be delighted to have the [unintelligible] that's coming out of our shale deposits of natural gas just lie there untapped for decades in the future and pay extra. You want your Arabs to use up their oil, but nobody else in America seems to feel my way, but I'm into deferred gratification.

The oil and gas is not going away, and I think it's just as important as the topsoil in Iowa. If any of you said, oh, goodie, I found a way to make money, we'll ship all our topsoil from Iowa to Greenland, I wouldn't think that was a very good idea, and so I don't think that hastening to use up all of our oil and gas is a good idea, but I'm practically the only one in the country that feels that way. There's not enough deferred gratification in it to please me, but I don't see any advantage. I regard our oil and gas reserves just as chemical feedstocks that are essential in civilization. Leave aside their energy content, I'd be delighted to use them up more

slowly. By the way, I'm sure I'm right and the other 99 percent of the people are wrong.

But no, I don't know. The oil and gas business is very peculiar. The people who succeed in most other businesses are doing way more physical volume than they did in the past. But a place like Exxon, the physical volume goes down by two thirds, it's just that the price of oil goes up faster than the physical volume goes down. That is a very peculiar way to make money and it may well continue, but it's confusing, we're not used to it.

MALE SPEAKER:

Mr. Munger, as an 18-year-old interested in many disciplines, I was wondering how you can thrive as a polymath in a world that celebrates specialization.

CHARLIE MUNGER:

Well, that's a good question. I don't think operating over many disciplines as I do is a good idea for most people. I think it's fun, that's why I've done it, and I'm better at it than most people would be, and I don't think I'm good at being the very best at handling differential equations. So it's been a wonderful path for me, but I think the correct path for everybody else is to specialize and get very good at something that society rewards and then get very efficient at doing it, but even if you do that, I think you should spend 10 or 20 percent of your time in trying to know all the big ideas in all the other disciplines. Otherwise, I use the same phrase over and over again…otherwise, you're like a one-legged man in an ass-kicking contest. It's just not going to work very well. You have to know the big ideas in all the disciplines to be safe if you have a life lived outside a cave. But no, I think you don't want to neglect your business as a dentist to think great thoughts about Proust.

MALE SPEAKER:

Mr. Munger, question about Lollapalooza effects. What are you observing now in your study of current events that's causing you concern, and how can you use that interdisciplinary approach to spot them in events? Thank you.

CHARLIE MUNGER:

Well, I coined that term the "Lollapalooza effect" because when I realized I didn't know any psychology and that was a mistake on my part, I bought the three main textbooks for introductory psychology and I read through them, and of course being Charlie Munger, I decided the psychologists were doing it all wrong and I could do it better. And one of the ideas that I came up with, which wasn't in any of the books, was that the Lollapalooza effects came when three or four of these tendencies were operating at once in the same situation.

I could see that it wasn't linear. You've got Lollapalooza effects, but the psychology people couldn't do experiments where four or five things were happening at once because it got too complicated for them and they couldn't publish, so they were ignoring the most important thing in their own profession.

And of course the other thing that was important was to synthesize psychology with all else, and the trouble with the psychology profession is they don't know anything about "all else" and you can't synthesize one thing you know with something you don't if you don't know the other thing, so that's why I came up with that Lollapalooza stuff. And by the way, I've been lonely ever since. I'm not making any ground there. And by the way, I'm totally right.

PAUL SMITH:

Charlie, I'm Paul Smith from Los Altos, California. My question relates to a comment you made some years ago about Warren Buffett. I think you said that he has become a significantly better investor since he turned 65, which I found a remarkable comment. I was wondering if you could share information about that that maybe we haven't heard before. I know you've commented he's a learning machine, and we all know the aversion to retail that came out of the Diversified episode, and so on. It would just be interesting, is there something that's changed about his risk assessment or his horizons, or any color there would be fantastic to hear? Thank you.

CHARLIE MUNGER:

Well, if you're in a game and you're passionate about learning more all the time and getting better and honing your own skills a little more, etcetera, etcetera, of course you do better over time and some people are better at that than others. It's amazing what Warren has done. Berkshire would be a very modest company now if Warren never learned anything. He never would've given anything back, I mean, any territory he took he was going to hold it.

But what really happened was, we were out in the new fields and buying whole businesses, and we bought into things like ISCAR that Warren never would have bought when he was younger. Ben Graham would have never bought ISCAR. He paid five times book or something for ISCAR. It wasn't in the Graham play[book], and Warren who learned under Graham, just, he learned better over time, and I've learned better.

The nice thing about the game we're in is that you can keep learning, and we're still doing it. Imagine we're in the press for CNBC for all of a sudden buying airline stocks. What have we said about the airline business? We thought it was a joke it was such a terrible business, and now if you put all of those stocks together we own one minor airline. We did the same thing in railroads. We said railroads are no damn good, you know, too many of them, truck competition, and we were right. It was a terrible business for about 80 years, but finally they got down to four big railroads and it was a better business, and something similar is happening in the airline business.

On the other hand, this very morning I sat down in my library with my daughter-in-law and she booked a round trip ticket to Europe, including taxes, it was like 4 or 5 hundred dollars. I was like, "we're buying into the airline business?" It may work out to be a good idea for the same reason that our railroad business turned out to be a good idea, but there's some chance that it might not.

In the old days, I frequently talked to Warren about the old days, and for years and

years and years, what we did was shoot fish in a barrel, but it was so easy that we didn't want to shoot at the fish while they were moving, so we waited until they slowed down and then we shot at them with a shotgun. It was just that easy, and it's gotten harder and harder and harder, and now we get little edges…before, we had total cinches, and it isn't any less interesting. We do not make the same returns we made when we could run around and pick this low-hanging fruit off trees that offered a lot of it.

So now we go into things. We bought the Exxon position. You want to know why Warren bought Exxon? As a cash substitute. He would never have done that in the old days. We had a lot of cash and we thought Exxon was better than cash over the short term. That's a different kind of thinking from the way Warren came up. He's changed, and I think he's changed when he buys airlines, and he's changed when he buys Apple.

Think of the hooting we've done over the years about high tech, we just don't understand it, it's not in our central competency, the worst business in the world is airlines, and what do we do? We appear in the press with Apple and a bunch of airlines. I don't think we've gone crazy. I think the answer is we're adapting reasonably to a business that's gotten very much more difficult, and I don't think we have a cinch in either of those positions. I think we have the odds a little bit in our favor, and if that's the best advantage we can get, we'll just have to live on the advantage we can get.

I used to say you have marry the best person that will have you, and I'm afraid that's a rule of life, and you have to get by in life with the best advantage you can get, and things have gotten so difficult in the investment world that we have to be satisfied with the type of advantage that we didn't use to get. On the other hand, the thing that caused it to be so difficult was when we got so enormously rich and that's not a bad tradeoff.

MALE SPEAKER:

Mr. Munger, at last year's meeting you said Donald Trump was not morally qualified to be President, and now that he is President, do you still agree with that, or do you think he's qualified in any capacity?

CHARLIE MUNGER:

Well, I've gotten more mellow. I always try and think about the good along with what's not good, and I think some of this stuff where they're reexamining options about the whole tax system of the country, I think that's a very constructive thing. When Donald Trump says he wouldn't touch Social Security, when a lot of highfalutin Republicans have all kinds of schemes for [unintelligible] Social Security, I'm with Donald Trump. If I were running the world I'd have his exact attitude about Social Security, I wouldn't touch it. So, he's not wrong on everything and just because he isn't like us…roll with it. Accept a little danger. What the hell, you're not going to live forever anyhow.

MALE SPEAKER:

Hi, Charlie. I was wondering what was the most meaningful thing that you did with your life?

CHARLIE MUNGER:

Well, I think that family and children is the most meaningful thing that most people do with their life, and I've been reasonably fortunate. I don't think I am a perfect husband. I'm lucky to have had as much felicity as I got, and I always needed a certain amount of toleration from the fair sex. I started wrong and I never completely fixed myself. I can tell this group about…you come here as a cult to talk to the cult leader? I want to take you back in history again. You'll see what an inferior person you're now trusting.

When I was a freshman in Omaha Central High, there was a family friend, a girl my age, and she had gone off to summer camp the year before and she met a blonde goddess, a voluptuous 13-year-old, and I was a skinny underdeveloped whatever and so forth. "You gotta take my blonde goddess to this dance". And so, I wanted to impress this blonde goddess and so I pretended to smoke, which I didn't, and she was wearing a net dress and I set her on fire, but I was quick-witted, and I threw a Coca-Cola all over her and in due time the fire was out, and that's the last I saw of the blonde goddess.

And then I said, well, I've got to make more time with the girls, and I wanted to get a letter at Omaha Central High. Of course, I was no good at any sport. So, I went down to the rifle range and learned they gave letters in rifle shooting, and I was so skinny that I could shoot a hundred every time in the sitting position by sitting cross-legged and putting one elbow on each foot, try it, you'll break your neck, but I could shoot a hundred every time. So I was a good rifle shooter and they gave me a letter, but I was so skinny and short and underdeveloped that it went from one armpit to the other, and I walked down the hallway trying to impress the girls and they wouldn't turn their head. What they said was, how did a skinny little unattractive little runt like that get a letter?

And then I had another experience. There was a girl who had a name, I still remember it, Zibby Bruington. She was a senior and a very popular senior, and I was a nerd sophomore, and somehow she agreed to go with me to a party in one of the out-buildings of the Omaha Country Club, perhaps because she liked one of my friends, who was a big strapping fellow. So I took Zibby to this party in my 1934 Ford, and it sleeted and got rainy and so forth, and I managed to stick the Ford in the mud and I couldn't get out of it, and Zibby and I had to walk for several miles through sleet. That was the last I ever saw of Zibby Bruington. And then my car stayed in the mud and I neglected to put in antifreeze, and the temperature went way down and suddenly the block broke. It was too expensive to fix. Then I lost my car and my father wouldn't buy a new one because he said why should I buy a new car for a guy whose dumb enough not to put antifreeze in it? This is the person you're coming for miles to see. And so, I didn't get a new car.

My life is just one long litany of mistakes and failure and it went on and on and on. And politics…I ran to be the president of the DSIC in grade school, The Dundee School Improvement

Association. I had the most popular boy in school as my campaign manager. I came in second by miles. I was a total failure in politics. There's hardly anything I succeeded at. Now, I tell you all of this because I know a nerd when I see one and there are a lot of nerds here who can tell stories like mine, and I want you to feel it's not hopeless. Just keep trying.

Oh, yeah, Guerin wants me to repeat the story of Max Plank. According to the story, Max Plank when he won the Nobel Prize was invited to run around Germany giving lectures and a chauffeur drove him, and after giving the lecture about 20 times, the chauffeur memorized it and he said, you know, since Professor Plank it's so boring, why don't you just sit in the audience and I, the chauffeur, will give your talk. And so, the chauffeur got up and gave Max Plank's talk on physics and some professors started asking some terrible questions and the chauffeur said, well, I'm surprised that in an advanced city like Munich, people are asking elementary questions like that. I'm going to ask my chauffeur to answer that.

While I'm telling jokes I might tell one of my favorite stories about the plane that's flying over the Mediterranean. The pilot's voice comes on and he says, 'A terrible thing just happened. We're losing both engines. We're going to have to land in the Mediterranean'. And he says, 'The plane will stay afloat for a very short time, and we'll be able to open the door just long enough so that everybody can get out. We have to do this in an orderly fashion. Everybody who can swim, go to the right wing and stand there, and everybody who can't swim go to the left wing and just stand there. And he says, those of you on the right wing, you'll find a little island in the direction of the sun, it's two miles off, and as the plane goes under just swim over to the island, you'll be fine, and for those of you on the left wing, thank you for flying Air Italia.

WILLIAM:

Hello, Mr. Munger. William [unintelligable]. Wonderful stories. With regard to the proliferation of index funds, do you think that there may be issues with liquidity any time we go through another large crisis? And then, do you think that that will create large discrepancies between the price of the index fund and the values of the securities underneath?

CHARLIE MUNGER:

Well, the index funds of the S&P, it's like 75 percent of the market, so I don't think the exact problem you're talking about is going to be a big problem because you're talking about the S&P index. But is there a point where index funds theoretically can't work? Of course. If everybody bought nothing but index funds, the whole world wouldn't work as people expect.

There's also the problem…one of the reasons you buy a big index like the S&P is because if you buy a small index and it gets popular, you have a self-defeating situation. When the Nifty 50 were the rage, JP Morgan talked everybody into buying just 50 stocks and they didn't care what the price was, they just bought those 50 stocks. Of course in due time, their own buying forced those 50 stocks up to 60 times earnings whereupon it broke and everything went down by like two-thirds quite fast. In other words, if you get too much faddishness in one sector or in one narrow index,

of course you can get catastrophic changes like they had with the Nifty 50 in that former era.

I don't see that happening when the index is three-quarters of the whole market. The problem is the whole thing can't work perfectly forever, but it will work for a long time. The indexes have caused just absolute agony among the intelligent investment professionals because basically 95 percent of the people have almost no chance of beating it over time, and yet all the people expect, if they have some money, they can hire somebody who will let them beat the indexes, and of course the honest, sensible people know we're selling something they can't quite deliver and that has to be agony. Most people handle that with denial. They think that it will be better next year, or they just don't want to think about that and I understand that. I mean, I don't want to think of my own death either, but it's a terrible problem, beating those indexes, and it's a problem that investment professionals didn't have in the past.

And what's happening of course is that the prices for managing really big sums of money are going down, down, down, 20 basis points and so on. The people who rose in investment management didn't do it by getting paid 20 basis points, but that's where we're going I think in terms of people who manage big portfolios of the American Equities in the equivalent of the S&P. It's a huge, huge, problem. It makes your generation of money managers have way more difficulties and it causes a lot of worry and fretfulness, and I think the people who are worried and fretful are absolutely right.

I would hate to manage a trillion dollars in the big stocks and try and beat the indexes. I don't think I could do it. In fact if you look at Berkshire, take out a hundred decisions, which is like two a year, the success of Berkshire came from two decisions a year over 50 years. We may have beaten the indexes, but we didn't do it by having big portfolios of securities and having subdivisions managing the drugs and subdivisions, and so the indexes are a hell of a problem for you people, but you know, why shouldn't life be hard? It's what had to happen, what's happened now.

If you take these people doing some of those early trading by computer algorithms that worked, then somebody else would come in and do the same thing with the same algorithm and play the same game, and of course the returns went down. Well, that's what's happening in the whole field is the returns you're really going to get are being pushed down by the progress of the sums.

NICK ANDERSON:

Thank you, Mr. Munger. My name is Nick Anderson. I'm from Brooklyn, California. I have two questions for you. My first question is what books or experiences were the most formative to you in your early career? And the second question is where and how do you tell your most ambitious grandchildren to look for business opportunities?

CHARLIE MUNGER:

Well, I don't spend any time telling my grandchildren what business opportunities to look for. I don't have that much hope. I'm going to have trouble getting my grandchildren to work at all. Anyway, I don't think there's an easy way to handle a problem of doing better and better with

finances. Obviously, if you're glued together and honorable and get up every morning and keep doing and keep learning every day, and you're willing to go in for a lot of deferred gratification all your life, you're going to succeed. It may not be as much as you want, but you're going to succeed. And so, the main thing is to just keep in there and be glued together, and get rid of your stupidities as fast as you can, and avoid the bad people as much as you can and you'll do reasonably well, but try teaching that to your grandchildren. I think the only way you have a chance is sort of by example, so if you want to improve your grandchildren, the best way is to fix yourself.

Oh, books. You cultists send me so many books that I can scarcely walk into my own library, so I'm reading so many now because I never throw one away, I at least scan and so I've gotten so I make a kaleidoscope of those new books. I just read this new book by [Ed] Thorp, the guy who beat the dealer in Las Vegas, and then he did computer algorithm trading. I really liked the book. For one thing, the guy had a really good marriage and he seemed grateful for it and it was touching. For another, he was a very smart man. He was a mathematician using a high IQ to, a) beat the dealer in Las Vegas and so forth, and then, b), use these computer algorithms to do this massive trading. I found it very interesting, and since some of you people are nerds and maybe you might like a love story, I recommend Thorp's new book. It's an interesting thing to do to beat the dealer in Las Vegas…wearing disguises and so on.

And Peter Kaufman told me a story about somebody he knows that did the same thing as Thorp did, he said he did it more extreme. He wore disguises and so forth. He won 4 million dollars I think in the casinos, and that was hard to do because casinos don't like playing against people who might win, and then he went into the stock market where he made 4 billion dollars, again clever algorithms. You know, these people are mathematically gifted. It's still going on, and I don't think many of you are going to do it. There can't be many people who are mathematically gifted enough and manipulate statistics and everything else so well that they find little algorithms that will make them 4 billion dollars, but there are a few, and so some of them started just like Thorp. So, Thorp's book is interesting and I recommend it to you.

MALE SPEAKER:

Hi, Mr. Munger. Thanks for being such a great teacher. This question, a position for the idea of filial piety, the Confucian idea. In this generation, how can we fulfil our filial duties?

CHARLIE MUNGER:

I didn't quite catch.

MALE SPEAKER:

How can we in my generation, I at least will be staying far away from my parents, so how can I fulfil my filial duties the best way as you see it?

CHARLIE MUNGER:

I like filial piety. They worship old men, rich old men. That is my kind of a system. But I think the idea of caring about your ancestors and caring about your traditions, I think all that stuff is a big part of what's desirable. I really admire the Confucians for that notion that it's not a game that's played just in one life. It's a game where you're handing the baton off, and you're accepting the baton from your predecessor. So if filial piety is your game, why, I think it's a very good thing. Think about how rootless we'd all be if we had no families at all, no predecessors, no decedents, it would be a very different life. Think what we owe the people who figure out things in the past that make our civilization work. So, I'm all for filial piety and its close cousins.

JESSE KOLTES:

Good morning, Mr. Munger. Jesse Koltes from New York. You said that "any year in which you don't destroy one of your best loved ideas is a wasted year." It's well known that you helped coach Warren towards quality, which was a difficult transition for him. I was wondering if you could speak to the hardest idea that you've ever destroyed.

CHARLIE MUNGER:

Well, I've done so many dumb things that I think I'm very busy destroying bad ideas because I keep having them, so it's hard for me to just single out one from such a multitude. But I actually like it when I destroy a bad idea because I think I remember…I guess it's my duty to destroy old ideas. I know so many people whose main problem in life is that the old ideas displace the entry of new ideas that are better. That is the absolute standard outcome in life. There's an old German folk saying that describes that, it says, "We're too soon old and too late smart." That's everybody's problem, and the reason we're too late smart is the stupid ideas we already have, we can't get rid of.

Now it's a good thing that we have that problem. In marriage that may be good for the stability of marriage that we stick with our old ideas, but in most fields you want to get rid of your old ideas. It's a good habit, and it gives you a big advantage in the competitive game of life, other people are so very bad at it. What happens is as you spout ideas out, what you're doing is you're pounding them in, and so you get these ideas and then you start agitating and saying them and so forth and of course, the person you're really convincing is you who already had the ideas. You're just pounding them in harder and harder.

One of the reasons I don't spend much time telling the world what I think about how the Federal Reserve System should behave, and so forth, is I know that I'm just pounding the ideas into my own head when I think I'm telling the other people how to run things. So, I think you have to have mental habits that...I don't like it when young people get violently convinced on every damn cause or something. They think they know everything. Some 17-year-old wants to tell the whole world what ought to be done about abortion or foreign policy in the Middle East or something. All he's doing when he or she spouts about what he deeply believes is pounding the ideas he already has in, which is a very dumb idea when you're just starting and have a lot to learn.

So, it's very important, that habit of getting rid of the dumb ideas. One of the things I do is pat myself on the back every time I get rid of the dumb idea. You'd say, could you really reinforce your own good behavior? Yeah, you can. When other people don't praise you, you can praise yourself. I have a big system of patting myself on the back. Every time I get rid of a much-beloved idea I pat myself on the back, sometimes several times, and I recommend this same mental habit to all of you. The price we pay for being able to accept a new idea is just awesomely large. Indeed, a lot of people die because they can't get new ideas through their head.

DONALD SCHAFFER:

Hello, Charlie. My name's Donald Schaffer. I used to work as a petroleum engineer and from my experience of that, and I was kind of in it through all of the whole shale stuff that's happened, and my perception is that as an industry itself it just continuously has gotten more and more complex and more technical, and that as the economy in general expands and you have more division of labor and specialization, it seems to me that it will be very hard, like it could be a challenge for investors unless there is some more specialization or something. I guess my question is as it gets more...do you think that capital allocators are going to need to become more specialized going forward?

CHARLIE MUNGER:

Well, you petroleum people of course have to get more specialized because the oil is harder to get, and you have to learn new tricks to get it, and so you're absolutely right. Generally, specialization is the way to go with people. It's just I have an example of something different. It's awkward for me because…but I don't want to encourage people to do it the way I did because I don't think it will work for most people. I think the basic ideas of being rational and disciplined and deferring gratification, those will work good. If you want to get rich the way I did by learning a little bit about a hell of a lot, I don't recommend it to others.

Now, I've get a story there that I tell. A young man comes to see Mozart and says, I want to compose symphonies. And Mozart says, you're too young to compose symphonies. He's 20 years old. He says, but you were composing symphonies when you were 10 years old and Mozart says, yeah, but I wasn't running around asking other people how to do it.

I don't think I'm a good example to the young. I don't want to encourage people to follow my particular path. I like all the general precepts, but I would not…if you're a proctologist, I do not want a proctologist that knows Schopenhauer, or astrophysics, I want a man who's specialized. That's the way the market is and you should never forget that. On the other hand, I don't think you'd have much of a life if all you did was proctology.

PHILIP:

Hi. Philip [unintelligable]. The question is for Charlie. Warren and you are known for saying that you worked with a small sum of capital, maybe like even 10 million dollars.

Warren publicly said that he could guarantee that if you compound that at 50 percent a year. So my question is can you provide some examples, and then I would kindly ask that you provide as many examples as possible, and be as specific as possible.

CHARLIE MUNGER:

Well, the minute I hear somebody that really wants to get rich at a rapid rate with specifics, that is not what we're trying to do here. You want to leave some mystery so that you yourself can amuse yourself, finding your own way. You know, the ideas that I've had in my life are quite few, but the lesson I can give you is a few, is all you need and don't be disappointed. When you find the few of course, you've got to act aggressively, that's the Munger system, and I learned that indirectly from a man I never met, which was my mother's maternal grandfather.

He was a pioneer when he came out to Iowa and fought in the Black Hawk War and so on, and eventually after enormous hardship...well, he was the richest man in town and he owned the bank and so on. As he sat there in his old age, my mother knew him because she'd go to Algona, Iowa, where he lived, had the big house in the middle of town, iron fence, capacious lawns, big barns. What Grandpa Ingham used to tell her is, there's just a few opportunities you get in a whole life. This guy took over Iowa when the land was black topsoil in Iowa was cheap, but he didn't get that many opportunities. It was just a few that enabled him to become prosperous.

He bought a few farms every time there was a panic, you know, and he'd lease them to thrifty Germans, you couldn't lose money with leasing a farm to a German in Iowa, but he only did a few things, and I'm afraid that's the case. You're not going to find a million wonderful ideas. These people with the computer algorithms do it, but they have a computer sifting the whole world. It's like placer mining, and of course every niche they're in, if somebody else comes in, the niche starts leaching away, and I don't think it's that honorable to make a living that way. I would rather make my money in some other way than outsmarting the trading system, so I have a little computer algorithm that just leaches a little out of everybody's trade.

I always say that those people have all the social utility of a bunch of rats in a granary. It's not that great a way to make money. I would say that if you make your money that way that you should be very charitable with it because you've got a lot to atone for. I don't think it's an ambition we should encourage, and the rest of us who aren't just leaching a little off the top because we're great at computer science, and that's what this room is full of, and if you're not finding it harder now, you don't understand it. That's my lesson.

CAMDEN:

Hi, Mr. Munger. My name is Camden [unintelligible] and I'd like to know what's your favorite industry and why it's your favorite industry?

CHARLIE MUNGER:

I didn't quite follow that.

CAMDEN:

All I wanted to know, what's your favorite industry and why it's your favorite industry?

CHARLIE MUNGER:

My favorite industry. Well, my favorite industry is taking care of my own affairs, and it's fun, it's creative, and it's the job that life has given me, and I think that you should do the job well that life gives you. A lot of the places where the industries are doing a great job for the world, it's very hard to make money out of it because these wild enthusiasms come into it. So, I don't have a favorite industry.

MALE SPEAKER:

Charlie, a few years ago you were [unintelligible] on and identifying the monkey business account. Is there any current monkey business in Corporate America that worries you?

CHARLIE MUNGER:

Well, the answer is yes, but not as extreme as Valeant. That was really something. That was really something. I probably shouldn't have done that, but you come so far, and since you're cult members you like being here, and I feel an obligation to tell you something sort of interesting, and I just went straight into Valeant that year. It was really pretty disgusting.

The interesting thing is how many high-grade people that took in. It was too good to be true. There was a lot wrong with Valeant. It was so aggressive. It was drugs people needed. It was just…take the difference between Valeant and the Daily Journal Company, and the foreclosure boom came, we had 80 percent of the foreclosure business in our area. It's a big area, Southern California and Northern California too. It would have been very easy for us to raise the prices and make, I don't know, 50 million more or something like that. All these people were losing their houses, a lot of them perfectly decent people.

It never…the idea that just right in the middle of that we'd make all the money we could, which some of our competitors did by the way. We just didn't do it. I don't think capitalism requires that you make all the money that you can. I think there are times when you should be satisfied with less based on just ideas of decency, and at Valeant they just looked at it like a game like chess. They didn't think about any human consequences, they didn't think about anything but getting what they wanted, which was money and glory, and they just stepped way over the line, and of course in the end they were cheating.

But I don't have a new one. I got a lot of publicity over that Valeant thing. I'm not looking for…I don't want this room to have twice as many people next year, and I don't want me not to be here either.

TIM MEDLEY:

Mr. Munger, Tim Medley. Thank you for your advice over the past 30 years. My question relates to a talk you gave to the Foundation Financial Officers in 1998 here in California, and in that talk you were critical of the complexity and the expense of many foundation portfolios and you said specifically, "An institution with almost all wealth invested long-term in just three fine domestic corporations is securely rich." And you gave as an example the Woodruff Foundation in Coca-Cola. So if you had a foundation today with let's say a billion dollars, would you be comfortable with it being invested in just three stocks?

CHARLIE MUNGER:

Well, let's take the foundation. I'll change your question around in order to answer it. Am I comfortable with a non-diversified portfolio? Of course I am. If you say the Mungers, I care about the Mungers. The Mungers have three stocks. We have a block of Berkshire, we have a block of Costco, we have a block of Li Lu's Fund, and the rest is dribs and drabs. So am I comfortable? Am I securely rich? You're damn right I am.

Could other people be just as comfortable as I who didn't have a vast portfolio with a lot of names in it, many of whom neither they nor their advisors understand? Of course they'd be better off if they did what I did. And is three stocks enough? What are the chances that Costco's going to fail? What are the chances that Berkshire Hathaway's going to fail? What are the chances that Li Lu's portfolio in China is going to fail? The chances that any one of those things happening is almost zero, the chances that all three of them are going to fail.

That's one of the good ideas I had when I was young. When I started investing my little piddly savings as a lawyer, I tried to figure out how much diversification I would need if I had a 10 percentage advantage every year over stocks generally. I just worked it out. I didn't have any formula. I just worked it out with my high school algebra, and I realized that if I was going to be there for 30 or 40 years, I'd be about 99 percent sure that it would be just fine if I never owned more than three stocks and my average holding period is three or four years.

Once I had done that with my little pencil, I just…I never for a moment believed this balderdash they teach about. Why diversification? Diversification is a rule for those who don't know anything. Warren calls them "know-nothing investors". If you're a know-nothing investor of course you're going to own the average, but if you're not a know-nothing investor, if you're actually capable of figuring out something that will work better, you're just hurting yourselves looking for 50 when three will suffice. Hell, one will suffice if you do it right, one. If you have one cinch, what else do you need in life?

And so, the whole idea that the know-something investor needs a lot of diversification, to think we're paying these professors to teach this crap to our young, and people think they should be paid by telling us to diversify. Where it's right, it's an idiot decision, and where it's wrong, you shouldn't be teaching what's wrong.

What's gone on in corporate finance teaching is that people are getting paid for dispensing balderdash, and since I never believed that it was a great help to me, it helps if you're out in the market and the other people are believing balderdash and you know what the hell's going on, it's a big help. So of course you don't want a lot.

If you're Uncle Horace, who has no children, has an immense business which is immensely secure and powerful and he's going to leave it all to you, if you come to work in the business you don't need any diversification. You don't need any corporate finance professors. You should go to work for Uncle Horace. It's a cinch. You only need one cinch, and sometimes the market gives you the equivalent of an Uncle Horace and when it does, step up to the pie-cart with a big pan. Pie carts like that don't come very often. When they do you have to have the gumption and the determination to seize the opportunity assuredly.

I was lucky. Imagine learning that from your dead great-grandfather at a very young age, but you know, I spent my whole life with dead people. They're so much better than many of the people I'm with here on earth. All the dead people in the world, you can learn a lot from them and they're very convenient to reach. You reach out and grab a book, none of those problems with transportation, so I really recommend making friends among the imminent dead, which of course I did very early, and it's been enormously helpful. Some of you wouldn't go with me, but Adam Smith really did.

MALE SPEAKER:

My question is about the Irish economy and Irish banking. I know that Berkshire Hathaway was a shareholder in Irish banks pre-2008. I'm wondering if you could you comment on how the Irish economy and the Irish banking system proceeds, with the UK not being part of the European Union, going forward.

CHARLIE MUNGER:

Well, that of course was a mistake, and it was a mistake that we shouldn't have made because both Warren and I know you can't really trust the figures put out by the banking industry, and the people who run banks are subject to enormous temptations that lead them astray because it's easy to make a bank report from earnings. But a thing that any idiot could do, which is make it a little more gamey, and of course that's dangerous and yet the temptations are very great. So we shouldn't have made that mistake, but we did. And that's a good lesson too that even if you're really good at something you will occasionally drift and do a dumb mistake.

And now what's the question about the bank? They went crazy in Ireland, the bankers, and we went crazy when we trusted their damn statements and it was a mistake. Now, what Ireland has done was very smart in reducing all these taxes. Not all the English-speaking people with practically no taxes, and there's a fair amount of charm and so forth in Ireland. It's not like it's a terrible place to be. They just sucked in half the world into Ireland where they got these…Gates went there very early with Microsoft, and so on, and they took a place that was really a backward place that had a sort of internal civil war for 60 or 70 years and bad opportunities, and they really

brought in a lot of prosperity, and they did that by this competitive lowering of taxes and so on.

So it worked for Ireland, so I think Ireland deserves a lot of credit for the way they advanced their country. And of course they were going to have a thing where all the countries keep trying to reduce their taxes to suck in the foreign…but it won't work for everybody, but it did work for Ireland. So I think Ireland deserves a lot of credit, and of course they recovered pretty well from a very major collapse. Irish are like the Scottish. I always think that those Gallics are pretty unusual people, and I'm very glad that I had a Scottish-Irish great-grandmother.

MALE SPEAKER:

Charlie, on your right.. I just want to thank you firstly and foremost for being such an amazing teacher to me and all the investors around the world. My question is in regards to Lee Kuan Yew, and you've on several occasions spoken about the economic miracle that is Singapore, and then how it was transferred on by Deng Xiaoping to China. What are your thoughts about India that's going through a similar change with the prime minister who also idolizes his people and wants to create a similar sort of situation? I'd like you're thoughts on that. Thank you.

CHARLIE MUNGER:

Well, that's a very intelligent question, and I'm not saying all the other questions weren't. I regard...Lee Kuan Yew may have been the best nation builder that ever lived. He took over a malarial swamp with no assets, no natural resources, nothing, surrounded by a bunch of Muslims who hated him, hated him. In fact, he was being spat out by the Muslim country. They didn't want a bunch of damn Chinese in their country. That's how Singapore was formed as a country, the Muslims spat it out. And so here he is, no assets, no money, no nothing. People were dying of malaria, lots of corruption, and he creates in a very short time, by historical standards, modern Singapore. It was a huge, huge, huge success. It was such a success, there is no other precedent in the history of the world that is any stronger.

Now China's more important because there are more Chinese, but you can give Lee Kuan Yew a lot of the credit for creating modern China because a lot of those pragmatic communist leaders, they saw a bunch of Chinese that were rich when they were poor and they said, to hell with this. Remember the old communist said, "I don't care whether the cat is black or white, I care whether he catches mice." He wanted some of the success that Singapore got and he copied the playbook. So I think the communist leadership that copied Lee Kuan Yew was right. I think Lee Kuan Yew was right. And of course, I have two busts of somebody else in my house, one is Benjamin Franklin, and the other is Lee Kuan Yew. So, that's what I think of him.

Now you turn to India, and I would say I'd rather work with a bunch of Chinese than I would Indian civilization mired down, caste system, over-population, assimilating the worst stupidities of the democratic system, which by the way Lee Kuan Yew avoided. It's hard to get anything done in India and the bribes are just awful. So all I can say is, it's not going to be easy for India to follow the example of Lee Kuan Yew.

I think that India will move ahead, but it is so defective as they get ahead, and of course the Indians I know are fabulous people. They're just as talented as the Chinese. I'm speaking about the Indian populace, but the system and the poverty and the corruption, and the crazy democratic thing where you let anybody that screams stop all progress, it mires India with problems that Lee Kuan Yew didn't have.

Now, I don't think those Indian problems are always easy to fix. Let me give you an example. The Korean steel company, POSCO, invented a new way of creating steel out of lousy iron ore and lousy coal. And there's some province in India that has lots of lousy iron ore and lots of lousy coal, which there's not much use for, and this one process would take their lousy iron ore and the coal and make a lot of steel, and they got a lot of cheap labor.

So. POSCO and India were made for each other, and they made a deal with the province to get together and use the POSCO know-how and the India lousy iron ore and lousy coal, and eight or nine or ten years later with everybody screaming and objecting and farmers lying down in the road, or whatever's going on, they canceled the whole thing. In China they would have just done it. Lee Kuan Yew would have done it in Malaysia. India is grossly defective because they've taken the worst aspects of our culture, allowing a whole bunch of idiots to scream and stop everything and they've copied it. And so, they have taken the worst aspects of democracy and then they forged their own chains and put them on themselves. So, no, I do not like the prospects of India compared to the prospects of…and I don't think that India's going to do as well as Lee Kuan Yew.

MALE SPEAKER:

Hi, my name's [unintelligible] and I'd like to ask a question about the [unintelligible] loss. In '73 your investment firm with Mr. Wheeler lost over 30 percent and again in '74. That's over half in two years, so what happened, and have you been doing it differently since then?

CHARLIE MUNGER:

Would you have him restate that for me because I don't hear as well as I used to?

MALE SPEAKER:

So, what happened in '73 and '74 when your investment firm lost over half?

CHARLIE MUNGER:

Oh, that's very simple. That is very easy. That's a good lesson. That's a good question. What happened is the value of my partnership where I was running, went down by 50 percent in one year, and the market went down by 40 percent or something. It was a once-in-30-year recession. I mean, monopoly newspapers were selling at three, four times earnings. At the bottom tick, I was down from the peak, 50 percent. You're right about that. That has happened to me three times in my Berkshire stock, so I regard it as part of manhood. If you're going to be in this game for the long pull, which is the way to do it, you'd better be able to handle a 50

percent decline without fussing too much about it. And so, my lesson to all of you is conduct your life so that you can handle a 50 percent decline with aplomb and grace. Don't try to avoid it. It will come. In fact, I would say if it doesn't come, you're not being aggressive enough.

WARREN:

Thank you for having us, and thank you for your awesome employees for tolerating many more people in here than normal. My question relates to...

CHARLIE MUNGER:

They might think it's their last chance.

MALE SPEAKER:

My question relates to your paper on the biases of psychology of human misjudgment. You spoke about choosing great people earlier, and I'm curious, how do you evaluate, handle, and manage people knowing they might exhibit or suffer from biases you are not? And how have you and Mr. Buffett become such fine judges of character, not just someone's skills and abilities?

CHARLIE MUNGER:

Well, I think partly we look smart because we pick such wonderful people to be our partners and our associates, even our employees and that's going on right here. Gerry Salzman is not normal. He looks normal, but he's a damn freak. Gerry does things across two or three disciplines that are almost beyond human and he's always been that way. By the way, he's just another Midwesterner. He's come out of the soil back there. So, we've been very lucky to have these wonderful people.

I wish…I'm not quite sure…I think one thing we've done that's helped us to get wonderful people, I always say the best way to get a good spouse is to deserve one, and the best way to get a good partner is to be a good partner yourself, and I think Warren and I have both done good with that, but whatever the reason we've had these marvelous partners, and they make us look a lot better than we are. You wouldn't even be here if Gerry Salzman weren't here. We did not have a number two choice to run the Daily Journal, and by the way, that happens to me all the time. We have an executive search or something, and there's a number one and number two is like going off a cliff and we really…we need one, but there aren't three good ones to pick where they're all good and one's a little better.

Every executive search I've had, it seems to me there's one guy who's fine and everybody else is the pigmy. I think good people are hard to find, and people like Warren and I have had wonderful people who we've worked with all our lives and time after time. That's one of the reasons Warren says he tap dances to work. You'd tap dance too if you interfaced with people Warren interfaces with all day. They're wonderful people and they win all the time instead of losing. Who doesn't like winning in good company? So, if you can duplicate that, why, you've got a great future. I think we were a little lucky, and I can't give you any luck.

MALE SPEAKER:

We have a Chinese platform that focuses on ready content on people trying to invest out of China, and China will become the largest pool of investment capital in the world just by nature of [unintelligible]. It's the largest economy in the world with 30 percent savings rate. So they haven't been able to invest because of capital controls, but that day will come, and since they're at least a half a century behind in understanding about investing, what would be the first thing that you would tell a Chinese person who wants to invest in the US? What should they do with their money when they're making their initial investment outside?

CHARLIE MUNGER:

Well, you've made an assumption I don't follow. If I were a Chinese person of vast intellect and talent, discipline, all the good qualities, I would invest in China, not the United States. I think the fruit is hanging lower there and some of the companies are more entrenched, so I don't agree with your proposition. I think they have a tendency to think we were backwards, therefore when we get rich we should go over and invest in America. I think it's always a mistake to look for a pie in the sky when you've got a big piece of pie right in your lap. And so, if I were…at current prices, I think an intelligent person would do better investing in China.

MALE SPEAKER:

First of all, thank you for being a great teacher. I have two questions. Right here you said everyone should spend 10 to 20 percent on some big ideas. What are one or two big ideas that you are talking about? And then second question is whether...

CHARLIE MUNGER:

I can't tell you what to invest in.

MALE SPEAKER:

No, I'm not saying the big idea is that you don't mean investment. You said specialize, but then spend time working on some big ideas.

CHARLIE MUNGER:

Well, the big ideas, I think you should be intelligent in improving yourself. You're way better to take on a really big important idea that comes up all the time than some little tiny idea that you might not face. So, I always tried to grab the really big ideas in every discipline because why piddle around with the little ones and ignore the big ones? Just all the big ideas in every discipline are just very, very, very useful.

Frequently, the problem in front of you is solvable if you reach outside the discipline you're in and the idea is just over the fence, but if you're trying to stay within the fence you won't find it. I've done that so much in my life it's almost embarrassing, and it makes me seem arrogant

because I will frequently reach into the other fellow's discipline and come up with an idea that he misses, and when I was young that caused me terrible problems. People hated me, and I probably shouldn't have been as brash as I was, and I probably shouldn't be as brash as I am now.

I haven't completed my self-improvement process. But it's so much fun to get the right idea a little outside your own profession, so if you're capable of doing it, by all means learn to do it, even if you just want to learn it defensively. I do not observe professional boundaries.

My doctor constantly writes PSA test, prostate specific antigen, and I just cross it out and he says, what the hell are you doing, why are you doing this? And I say, well now, I'm trying to give you an opportunity to do something dumb. If I've got an unfixable cancer that's growing fast in my prostate I'd like to find out three months in the future, not right now, and if I got one that's growing slowly, I don't want to encourage some doctor to do something dumb and intervene with it, so I say, I just cross it out. Most people are not crossing out their doctor's prescriptions, but I think I know better. I don't know better about the complex treatments and so forth, but I know it's unwise for me to have a PSA test, so I just cross it out. I'm always doing that kind of thing and I recommend it to you when you get my age, just go cross out that PSA test. Now the women I can't help.

MALE SPEAKER:

I want you imagine you had the opportunity to invest in a couple money managers that you really liked, and they offer you a couple different ways to invest in a strategy. So, one way is through a limited partnership that would flow through the taxes, and the other way is through a corporation that would pay tax on the gains and the dividends. So basically, the corporation would serve no other function though, other than paying taxes. So, I think you'd be crazy to say that there is two ways of investing equally desirable, so my question is...

CHARLIE MUNGER:

You're certainly right about that. It's plumb crazy, and that's exactly the way people who buy Berkshire are investing. It's plumb crazy to have a big common stock portfolio in a corporation and pay taxes compared to investing in a partnership that doesn't, and that's just the way the Berkshire shareholders have invested and they have made, whatever it is, 25 percent a year since we were there. But you're right, it's not the logical way to do it.

MALE SPEAKER:

So my question is if you had to decide to invest in pool A or pool B, how would you decide on it? What method you would use to figure out what discount would make you indifferent to whether you would invest through the corporate tax-paying structure when it flows to the…

CHARLIE MUNGER:

I think it is totally asinine to invest in a portfolio of common stock through a corporation taxed under the Internal Revenue Code under Subchapter C or something, totally asinine. At

Berkshire, the public securities keep going down and down as a percentage of the total value, so it doesn't matter, we're getting to be sort of a normal corporation, but I don't think anybody's right mind should invest through a corporation in a puddle of securities. In fact, the disadvantage is so horrible. So, I wouldn't even consider it. In other words…and I regard it as a minor miracle that we were able to get where we did. So, of course you'd invest in a partnership.

MALE SPEAKER:

So, when anyone who invests in Berkshire has to decide what discount to put on a pool of securities that has a future tax lien on the gains, do you have any mental model for…

CHARLIE MUNGER:

Yeah, my model is to avoid it. We don't want to invest in a portfolio of securities in somebody else's corporation. You're totally right, which you already knew by the way.

SANDRA:

Mr. Munger, I am Sandra from China and I want to know what's your new findings of China, would you say business opportunities or just different because I remember you once said the Chinese were the first to be the one and got [unintelligible] years [unintelligible]. And also, a second question is after the US election the Hedge Fund Manager, Ray Dalio, said the new administration could unleash the animal spirits which could lead to a better US economy? Do you buy this theory? Thank you.

CHARLIE MUNGER:

Well, I'm not sure I understood that completely, but I'll do my best. What I like about China is that they have some companies that are very strong and still selling at low prices, and the Chinese are formidable workers and they make wonderful employees, and there's a lot of strength in that system. And the Chinese government really tries to help its businesses, it does not behave like the government of India, which I don't think runs its country right at all, and so that's what I like about China.

Of course, I have to admire taking a billion and half people in a state of poverty up that fast. That was never done in the history of the world and I admire them. You go to China, all those bullet trains that go into the heart of the city, what they've done is just an incredible achievement and they've done it not by borrowing money from Europe the way we did when we came up. They have taken a poor nation with a lot of poverty, and what they did is save half their income when they were poor and drive their nation way up with a lot of deferred gratification, so it was unbelievably admirable and unbelievably effective, so I admire that part of the Chinese picture.

China has one problem. The problem with the Chinese people is they like to gamble and they actually believe in luck. Now that is stupid. What you don't want to believe in is luck. You want to believe in odds and China, there's some reason in the culture,

too many people believe in luck and gamble and that's a national defect.

MS. ALEX MANFELD:

Hi. My name's Alex Manfeld. I work with John Griffin in New York. I was curious, if the world changes a lot during a lifetime, by the time I'm closer to your age, what do you think will not change about what makes a good successful business?

CHARLIE MUNGER:

What will not change is that it won't be that damned easy. There will be lots of… people will die that you love. You'll have close breaks where it goes against you. There's a lot of trouble that's sure to come, and at the end you'll know that it's all over, and that's the game. It's a very funny game when you know when you start you have to lose. See, a dog doesn't have to do that. We know from the start we can't win.

Somebody right said that the law of thermodynamics ought to be restated. You can't win, you must lose, and you can't get out of the game. So we all face this ultimate difficultly, but once you've accepted the limitations, you've got the problem how to get through your allot and expand reasonably well, and I don't think that's that hard to figure out because if you do pretty well, considering what you started with and so forth, and you stand at the end and you've done incredibly, you've helped other people who needed help because you had the capacity and intelligence to do it and so on, and so on. Set a reasonable example. It's a pretty good thing to do and it's quite interesting and the difficulties make it interesting.

And something else happens that is really weird. We were talking about, in our director's meeting that preceded this meeting, you always get glitches in something as complicated as a new software program going into a big new area, and you suddenly have reverses and troubles and you're scrambling. And what I said is that I've noticed in a long lifetime that the people who really love you are the people where you scramble together with difficulty and you've jointly gotten through, and in the end those people will love you more than somebody who's just shared in an even prosperity through the whole thing.

So, this adversity that seems so awful when you're scrambling through it actually is the [unintellible] of your success, your affection, every other damn thing, and if you didn't have the adversity you wouldn't have the bonds which are so useful in life that are going to come from handling adversity well. The idea that life is a series of adversities and each one is an opportunity to behave well instead of badly is a very, very, good idea, and I certainly recommend it to everybody in the room, and it works so well in old age because you get so many adversities you can't fix, so you better have some technique for welcoming those adversities.

SHAREE:

Hi, Charlie. My name is Sharee. You tell somehow one should situate themselves in a way where they can deal with a 50 percent downturn in a portfolio. For investor forming a partnership in

today's competitive market, focus concentrating in those few and rare wonderful opportunities, do you believe that the 0/6/25 high watermark fees structure that the Buffett Partnership popularized is the fairest structure for both limited partners and the manager themselves? And could you also touch upon what fee structure you employed during your partnership? Thank you.

CHARLIE MUNGER:

Well, I did copy the Buffett formula more or less, and I do think it's fair, and I think it's still fair, and I'm looking at Mohnish who still uses it. I think it is fair and I wish it was more common. I basically don't like it where businesses are scraping it off the top. If you're advising other people, you ought to be pretty rich pretty soon. Why would I take a lot of advice from somebody who couldn't himself get pretty rich pretty soon? And if you're pretty rich, why shouldn't you put your money alongside your investors and grow up and down with them. And if there's a bad stretch, why should you scrape money off the top when they're going down and up? So I like the Buffett system, but it's like so many things I like, it's not spreading very much. My net influence in the world, even Warren's, has been pretty small. Imagine how much copying we have in our executive compensation methods. It's about three examples. Yes, I think it's a fine system.

MALE SPEAKER:

Hello. You spoke earlier about natural gas and the shipping of natural gas and that activity…

CHARLIE MUNGER:

If I were running the world as a benign despot, I wouldn't be shipping any natural gas outside of the United States.

MALE SPEAKER:

So, to tap into that view, you've been active in two states that are big in agriculture, Nebraska and California produce. What are your thoughts on the ag industry specifically tied to subsidies, all that stuff? I would think you'd view it as outdated and maybe it's threatening a lot of resources, maybe just inefficient and based on past metals. What's your thought on ag and subsidies?

CHARLIE MUNGER:

Well, the interesting thing about agriculture is what's happened in my lifetime, which is the productivity of naked land has gone up about 300 percent, and if it weren't for that there would be a lot of starvation on earth. So, the ag system is one of the most interesting things that has happened in the last 60 or 70 years, and we literally tripled the [unintelligible] of land and we did it all over the world, and there was just a few people who did it, the Rockefellers, Borlaug, and so forth. It was one of the most remarkable things in the whole history of the earth and we need another doubling, and we're probably going to get it and it's absolutely incredible how well we've done, and it's amazing how efficient our farmers are.

We don't have much socialization in farming. We've got a bunch of people who own the farms and manage them themselves. There's not much waste and stupidity in farming. Now people complain that we're using up the topsoil, which I think we are, and I think that's more of a mistake. I would fix that if I were a benign despot, but leaving aside using up the topsoil up too fast, I think farming is one of the glories of civilization, so I think it's been wonderful what's happened in farming.

Now in terms of subsidies, it matters to the farmers where they get their subsidies, and there's no question about the fact that we've protected our farmers with subsidies, and the farmers we're protecting are getting richer and richer because the farms are owned by fewer and fewer people, own more and more acres per person. So, it's very peculiar that we're subsidizing people who are already filthy rich, to use up our topsoil a little faster and create stuff which we turn into ethanol, which is one of the stupidest ideas the world ever…you know, I'm a specialist in stupid ideas, but I would say turning corn into gasoline is about as stupid an idea.

I would almost rather jump out of a 20-story building and think I could fly than turn daggamit corn into motor fuel, it's really stupid, and yet that's what our politics does. I've got no cure for the stupidity of politics. If I did the world it would be quite different, but I think that's pretty minor whether we have subsidies or not. The main thing that's happening that has enabled the present population of the world to stay alive is this agricultural revolution, and this very good management of our farmlands, and the improving agricultural standards in the rest of the world, and it's gone on quietly that we haven't even noticed it hardly.

How many of you are just deeply aware of the fact that grain per acre has gone up by 3 or 4 hundred percent? That's a huge stunt. And by the way, if you take those marigold seeds and don't use hydrocarbons, the yields are lousy. We're feeding ourselves because we don't know how to turn oil into food. That's one of the reasons I want to hold onto the oil. Something that can be turned into food is quite basic, and so I don't mind conserving the oil instead of producing every last drop as fast as one can. It's odd that my idea hasn't spread to more of the people. I may have three or four other people who agree with me in this room, but you're a bunch of admirers, in the rest of the world I'm all alone.

MALE SPEAKER:

Hello, Charlie. Thank you for mentoring us. My question is this. You talked about emotions, you talked about discipline, and you talked about facing adversity. Can you flesh out more about the spiritual side of this, about how do you deal with it to pass up adversity with dealing with the struggles and ultimately life? Yeah.

CHARLIE MUNGER:

Well, just because you don't have a specific theology and I don't…you know, when I was a little kid and my grandfather sent me to bible school and they told me there was a talking snake in the Garden of Eden, I was very young, but I didn't believe them and I haven't changed. It doesn't mean I am not spiritual. I just don't need a talking snake to make me

behave well, and I would say that the idea that came down to me, partly through my family, was that rationality is a moral duty. If you're capable of being reasonable, it's a moral failure to be unreasonable when you have the capacity to be reasonable. I think that's a hair shirt that we should all take on, even if we're pretty stupid because it's good to be less stupid.

So I think rationality is a moral duty and we all have a duty to get better, and of course we also have to adjust to the other people who we're going through our journey with. I think it would be crazy not to have a social safety net when you're as rich and successful as we are. Now I don't think it has to be as dumb as the one we have, but of course we need a solid social safety net and that's a moral idea. So I'm all for morality without the talking snakes.

GERRY:

We're going to take two or three more questions and then I think Charlie will be here immediately after. And we have copies of two of Charlie's writings. I think we made 400 copies and they would available on your way out. And also you probably...

CHARLIE MUNGER:

I was cleaning out my office because we're moving and we just found these damn things, and [unintelligible] coming up from India and China. I gave them my old things. I haven't even read them in years and years, so I'm just visiting some of my past screens.

DAVID:

Mr. Munger, Berkshire is the largest shareholder of Phillips 66, and Phillips 66 owns a general partner and limited partner stakes in two different MLPs. I was wondering what your thoughts are on the Master Limited Partnership structure in industry? And also, I was wonder if you have any preliminary thoughts on the proposed border adjustment tax.

CHARLIE MUNGER:

Well, let me take the last question first. David, we do not know what the border adjustment tax is. I don't think the people who are proposing it know what it is, and I don't think Trump and the Republicans in Congress have agreed on anything. So I think we're just talking about… but do I think that some people rewriting the tax system might be a very good idea? The answer is yes. Do I think we should rely on consumption tax more? The answer is yes. Do I really care if somebody piles up a lot of money and leaves it to some foundation? That's not my idea of a big evil. If they do want to live high on their private airplanes and their 300 dollar dinner checks, I'm all for taxing the people who are living high. So I like the idea of bigger consumption taxes, and I think there's a lot to be said for a different kind of a tax structure.

MALE SPEAKER:

Hi, Mr. Munger. You highlighted this idea of deferred gratification a lot today, and I just wanted to get your thoughts on what areas and aspects of life is it most valuable, and where should you not be [unintelligible] should you enjoy things now versus when you should just grind away and invest in the future? Thanks.

CHARLIE MUNGER:

Well, I don't think you should use up your body by being stupid in handling it, and I don't think you should be stupid in handling your money either, and I think there are a lot of things where the only way to win is to work a long time towards a goal that doesn't come easily. Imagine becoming a doctor. That is a long grind, all those night shifts in the hospital and so and so on, it's deferred gratification, but it's a very honorable activity, being a doctor, and by and large our doctors are very nice people and they've been through a lot. So, I tend to admire the life of a doctor more than I admire the life of a derivatives trader and I hope all of you do too, and I think deferred gratification in the way our doctors behave is a very good thing for all the rest of us.

MALE SPEAKER:

I had a very general question about the Circle of Competence. How do you know its limit and does it get redrawn from time to time, you think you know something and then you don't? Does it always expand or does it contract?

CHARLIE MUNGER:

Well of course, you know some things that aren't so. Of course if you're dealing with a complex system, the rules of thumb that worked in the complex system in year one may not work in year 40, so in both cases it's hard. The laws of physics you can count on, but the rules of thumb in a complex civilization changes as the civilization changes, and so you have to live with both kinds of uncertainty and you have to work longer. It's not a bad thing. It's interesting. We're all the same here…who would want to live in a state of sameness? You might as well be dead.

Charles T. Munger

A PARODY DESCRIBING THE CONTRIBUTIONS OF WANTMORE, TWEAKMORE, TOTALSCUM, COUNTWRONG, AND OBLIVIOUS TO THE TRAGIC "GREAT RECESSION" IN BONEHEADIA AND THE THOUGHTS OF SOME PEOPLE RELATING TO THIS DISASTER

In the country of Boneheadia there was a man, Wantmore, who earned his income as a home mortgage loan originator. Wantmore operated conservatively. All his home loans bore interest rates of 6% or less, and he demanded of all borrowers large down payments, documented proof of adequate income and an immaculate credit-using history. Wantmore sold all his loans to life insurance companies that, before closing purchases, checked loan quality with rigor—then held all loans to maturity.

As Wantmore prospered, he eventually attracted the attention of Tweakmore, a very bold and ingenious investment banker. There was no other investment banker quite like Tweakmore, even in the United States.

Tweakmore had become the richest person in Boneheadia, driven by an insight that had come to him when, as a college student, he had visited a collection of hotels that contained gambling casinos located in a desert.

As Tweakmore saw immense amounts of cash pouring into cashiers' cages surrounded by endless sand, in business operations that did not tie up any capital in inventories, receivables, or manufacturing equipment, he realized immediately that he was looking at the best business model in the world, provided one could also eliminate commitment of any capital or expense to hotel rooms, restaurants, or facilities providing parking or entertainment.

Tweakmore also saw exactly how he could create for himself an operation that possessed all the characteristics of his ideal business. All he had to do was add to investment banking a lot of activities that were the functional equivalent of casino gambling, with the bank having the traditional "house advantage." Such casino-type activities, masked by respectable sounding labels, Tweakmore foresaw, could easily grow to dwarf all the action in ordinary casinos.

Determined to create and own his ideal business as fast as possible, Tweakmore quit college and entered investment banking.

Within twelve years, Tweakmore was the most important investment banker in Boneheadia. Tweakmore rose so rapidly because he was very successful in convincing regulators and legislators to enlarge what was permissible.

Indeed, by the time Tweakmore called on Wantmore, any investment bank in Boneheadia could invent and trade in any bets it wished, provided they were called "derivatives," designed to make counterparties feel better about total financial risks in their lives, outcomes that automatically happened. Moreover, an investment bank faced no limit on

the amount of financial leverage it employed in trading or investing in derivatives or anything else. Also, Tweakmore had obtained permission to use "Mark-To-Model" accounting that enabled each bank to report in its derivative book whatever profit it desired to report. As a result, almost every investment bank claimed ever-growing profits and had ownership of assets totaling at least thirty times an ever-swelling reported net worth. And despite a vast expansion of transaction-clearance risk, no big mess had so far occurred.

Tweakmore was pleased, but not satisfied, by what he had accomplished. And he now planned to revolutionize Boneheadia's home mortgage loan business in a manner that would make Tweakmore a national hero.

In his first proposal to Wantmore, Tweakmore held much of his ingenuity in reserve. All he proposed was that Wantmore hereafter sell all his home loans to Tweakmore at a higher price than life insurers would pay. Tweakmore said that he planned to put all loans into trusts with no other assets. Each trust would be divided into five "tranches" with different priorities in use of loan payments. Four tranches would use their shares of loan payments to pay off complex new fixed-interest-bearing, freely-tradable debt instruments, called CDOs . The fifth tranch got a tiny residue in case all home loan payments were received as due. The CDOs would be sold by Tweakmore, using a highly-paid sales force, to anyone who could be induced to buy, even highly-leveraged speculators and small Scandinavian cities in the Arctic.

To Wantmore, Tweakmore's proposal at first appeared unfeasible. The planned operation seemed to resemble the operation of a meat vendor who routinely bought 1000 pounds of chuck roast, sliced it up, and then sold 950 pounds as filet mignon and the balance as dog food.

But Wantmore's doubts melted away when Tweakmore revealed how much he would pay. Under the offered terms, Wantmore would double his income, something Tweakmore could easily afford because his own income was going to be three times that of Wantmore. After Wantmore accepted Tweakmore's proposal, everything worked out exactly as Tweakmore had planned, because buyers of CDOs in aggregate paid much more than the life insurers had formerly paid.

Even so, Wantmore, as he became familiar with Tweakmore's prosperity, was soon dissatisfied with a merely doubled income. With Wantmore restive, Tweakmore now displayed the full range of his ingenuity.

What Tweakmore next proposed was that Wantmore add to his product line a new class of "subprime, pay-what-you-wish" home mortgage loans. All loans would bear interest at 7½% or more, and borrowers would not be allowed to state anything except that they wanted the money. There would be no down payments and no credit checks or the like. Also, each loan would be very user-friendly in its first three years, during which the borrower could make only tiny payments with all unpaid interest being added to principal. After three years, very onerous loan service was required, designed to pay off the greatly swollen principal, plus all interest, over the next five years.

This proposal would have seemed preposterous, even hilariously satirical, if it had been presented to Wantmore when Tweakmore had first called. But by now Wantmore had doubled his income by going along with a peculiar idea of Tweakmore's. So Wantmore's credulity was easily stretched to allow acceptance of the new loan product, which Tweakmore projected would triple Wantmore's already doubled income.

It is easy to see why Wantmore became a "true believer" in the new loan product. But why did the already super-rich, prominent, and sophisticated Tweakmore believe his revised scheme would work safely and well for him?

Well, we know the answer. As Tweakmore revealed in his prideful autobiography, his thought process was as follows:

1. There would be no significant troubles during the first three years. Under the accounting standards of Boneheadia, all its accountants would be required for a long time to reserve no loan-loss provision at all against unpaid principal and unpaid interest on the new loans. And CDOs would be valued highly in trading markets because underlying loans were booked at unreasonably high value. It wouldn't matter that homebuyers were making no down payments, had no personal liability at any time, and paid only a tiny portion of interest accrued for three years. It also wouldn't matter that that any competent inquiry would have revealed extreme past improvidence on the part of most borrowers.
2. House prices in Boneheadia would not merely rise as they had done before. Prices would rise much faster as more and more people learned they could bid to acquire homes without using any of their own money, no matter how poor were their credit-using histories.
3. All the buyers of new CDOs would have a near perfect investment experience. Ever-rising house prices would cause full payment of all mortgage debt as due. The market for the new CDOs would expand and expand as investors reliably earned much more interest than they could get elsewhere. House prices in Boneheadia would rise faster and faster as the scheme fed on itself in a runaway feedback mode.
4. True, after the first three years many over-stretched homebuyers were sure to suffer somewhat as they were forced, by threats of foreclosure, to sell their homes. This would often cost them their credit and the respect of their children, friends, and employers, but that would be the only trouble, and it would prove endurable by Tweakmore and everyone else, except the people forced out of homes.
5. The runaway feedback mode that drove up house prices would cause no significant trouble for decades, as had happened in Japan where a big bust in real estate prices occurred only after the Imperial Palace grounds in Tokyo were apparently worth more than the market value of the entire state of California.
6. The principles of economics would give the scheme a large tailwind and considerable popularity. As Tweakmore, a former student in elementary economics, knew from studying Galbraith, a large undisclosed embezzlement strongly stimulates spending because the perpetrator is much richer and the victim spends as before because he does not yet feel poorer. And what Tweakmore was creating was the functional equivalent of

a long-running undisclosed embezzlement on steroids. The perpetrators would not be the only ones to spend more, as typically occurs during ordinary embezzlements. The CDO-buying victims also would spend more as they believed they were getting richer and richer from ever-growing paper gains embodied in accrual of interest at above normal rates.

7. To be sure, the scheme looked a little like a chain-letter scheme, and such schemes were usually ill regarded by prospective users, partly because the schemes were criminal and partly because the schemes always blew up so quickly, bringing criminal troubles so soon. Tweakmore's scheme, in contrast, would, by design, be lawful and benevolent, and recognized as such, because it would create big macroeconomic stimulus as a public good.
8. And should the scheme eventually blow up after decades, like the land-price bubble in Japan, who could fairly blame Tweakmore? Nothing lasts forever. Besides, the blowup might be lost in a miasma of other blowups like those sure to come in many irresponsible countries and subdivisions of countries.

Tweakmore's revised scheme worked fantastically well for a considerable period. Naturally, there were some glitches, but Tweakmore turned each glitch into an opportunity to boost profit. For instance, when Wantmore was made nervous as hordes of scumball salesmen were drawn into his business by rich commissions paid for production of easy-to-sell "subprime" pay-what-you-wish home loans, Tweakmore responded by buying Wantmore's business. Then Tweakmore replaced Wantmore with a new CEO, Totalscum, who did not consider any business practice optimal unless it was depraved. Totalscum soon increased loan production by 400%, and his success caused Tweakmore to buy five additional loan businesses and replace their CEOs with people like Totalscum, causing profits to soar and soar, even though Tweakmore never again found anyone else whose depraved operations could produce results that matched those of Totalscum.

As Tweakmore's scheme went on, it was necessary for its continuing success that the accountants of Boneheadia never stop treating as trustworthy a lot of hugely important loan-payment promises that any sensible person would deem unreliable. However, there was almost no risk that accountants would act otherwise than as Tweakmore desired. The accountants of Boneheadia were not allowed to be sensible. They had to use by rote "rules-based" accounting standards set by a dominating man, Countwrong, who was head of Boneheadia's Accounting Standards Setting Board. And Countwrong had ordained, in effect, that all loss provisions on the new loans must remain based on the zero-loss record that had existed before Wantmore met Tweakmore. And, so long as Countwrong was in charge, no one was going to use in accounting an understanding of runaway feedback modes, instead of Countwrong's rules.

Of course, if Totalscum or Tweakmore ever started to have loan losses, he would have to start making loan-loss provisions against new loans. But there weren't any meaningful loan losses for anyone for a very long time.

Countwrong was so habit-bound as a thinker that he never recognized that his cognition was anti-social. He had always sought simplicity of process for accountants at the expense of

"principles-based" rigor in thought that would better serve his country. He had been rewarded in life for his convictions, and he was now proud of his conclusions, even as they were contributing mightily to the super-catastrophe sure to come eventually from Tweakmore's scheme.

A large economic boom occurred in Boneheadia just as Tweakmore had expected. The boom made the regulators of Boneheadia feel extremely good about themselves as they passively watched the ever-enlarging operations of Tweakmore and Totalscum.

A famous regulator named Oblivious was particularly approving. He had been over-influenced in early life by classical economics. So influenced, Oblivious loved all the new derivatives, even those based on outcomes of parts of complex CDOs composed of parts of other complex CDOs. And he did not believe the government should rein in any investment banker until the banker's behavior was very much worse than Tweakmore's.

The boom initiated by Tweakmore lasted only three years. He had underestimated the boom's strength and the power of people to understand, in due course, super-sized folly. These factors had helped shorten the boom's duration. Also, Boneheadia had proved less like Japan than had been hoped.

When the boom-ending bust came, it was a doozy. Almost every investment bank had been made collapse-prone by Tweakmore's innovations before he became interested in home loans. And now, in a huge bust, most big financial institutions were sure to disappear, causing total chaos and another "Great Depression" unless there was super-massive intervention by the government, financed by printing money.

Fortunately, Boneheadia did so intervene, guided by effective leaders who somehow obtained support from politicians in both political parties. And, after this massive intervention, Boneheadia, with doubled unemployment, is enormously worse off than if the boom and bust had never happened. And its options in case of future trouble are greatly reduced because, after its money-printing spree, it is nearer to facing general distrust of its money and credit.

Boneheadia's bust is now called the "Great Recession." Yet, even so, not much has been learned by the elite in Boneheadia. Among the protagonists and too-passive types who contributed so much to the mess, only one has expressed significant contrition. To his great credit, Oblivious has recognized that he was grossly wrong.

The accounting profession remains unaware of its large contribution to public woe. And it does not recognize the cognitive defects of Countwrong, which are still believed to be virtuous qualities that reduce accountants' litigation risks and their duty to cause antagonism by opposing the wishes of some of their best-paying clients.

The professoriate in economics has barely budged toward recognition of the importance of optimized, more conservative accounting in both macroeconomics and microeconomics. And economics professors, even now, do not recognize what was so easily recognized by Tweakmore: the functional equivalent of undisclosed embezzlement can be magnified and have

massive macroeconomic consequences when the victims, as well as the perpetrators, are led to believe they are getting richer under conditions that are going to last for a long time.

How about the legislators in Boneheadia? Well, most are confused by what has happened to their most powerful friends and draw no useful implications from the outcome of Canadia, a country just north of Boneheadia that had no "Great Recession" because its simple laws and regulations kept in place home loan operations much like those of Wantmore before he embraced modern finance in the state preferred by Tweakmore.

How about the regulators? Well, very few important regulators or former regulators in all Boneheadia have expressed really serious doubts about the status quo and interest in really serious re-regulation of investment banking. One of the doubters is Follyseer, a long-retired former Minister of Finance. Follyseer has argued that all the contributions of Tweakmore to investment banking should now be removed and banned, because it is now obvious that (1) augmenting casino-type activities in investment banks was never a good idea, and (2) investment banks are less likely to cause vast public damage when they are forbidden to use much financial leverage and are limited to few long-traditional activities.

Regarding accounting, no regulator now in power seems to understand, in a way that has any chance of causing effective remedial action, that the disaster triggered by Tweakmore couldn't have happened if Boneheadia's system of accounting regulation had been more "principles-based," with a different and less tradition-bound group creating accounting standards that were less easy to game.

The former regulator and life-long professor who seemed extra wise after the Great Recession was England's John Maynard Keynes, dead for more than half a century. Keynes had predicted, correctly, that "When the capital development of a country is a by-product of the operations of a casino, the job is likely to be ill-done."

Charlie Munger

Afterword: The foregoing parody is not an attempt to describe in a fair way real contributions to the "Great Recession" in the United States. Certain characters and industries, for instance, Tweakmore and investment banking, are grossly overdrawn as contributors to sin and mayhem, while other contributors are not discussed at all. The whole idea was to draw attention to certain issues in accounting, academic economics, and conceivable over-development of finance as a percentage of the entire economy, by making the characters and the story line extreme enough to be memorable.

DRAFT
January 26, 1984

The practice of playing the stock market for relatively short-term gains has now reached such a high level that it tends to give a bad name to capitalism, thus threatening the cornucopia of goods and freedoms which only capitalism can provide. The country would be improved by revision of its income tax law to reduce such activity, instead of treating it as a treasured national resource.

Short-term stockholdings are the norm for take-over arbitrageurs and now-numerous "professional-bad-guy" investors (often called "raiders" by their detractors) who buy stock in quantities sufficient to create or enhance take-over threats and compound their stakes and encourage imitation as they are, more often than not, bought out at a profit either by the threatened corporation or in some forced sell-out of the corporation's entire business. But the largest share of short-term stockholding now occurs in simple super-activity by securities' portfolio managers as each seeks to be better than the others in predicting short-run changes in security prices. As large fees, commissions and other paper-shuffling profits are earned in the course of increased short-term activity, the result is augmentation of a prosperous class of "new capitalists," not at all in the mold of Andrew Carnegie, who tend to do for the reputation of capitalism what the court of Louis XVI did for the reputation of monarchy.

Too much easy money is now being made by too many pie-divider types as distinguished from pie-producer types. This is bound to raise anticapitalistic sentiments as it is increasingly recognized, for instance, (1) that the work of one good dentist does more for general felicity than that of thousands of investment counselors whose clients in aggregate are poorer for their efforts as they try to out-perform one another in hyperactive management of pension fund common stock portfolios, and (2) that most of these investment counselors (and stockbrokers and others who service them) are honorable, energetic, often brilliant people who would be more useful in other employment if not drawn by financial incentives to their present pursuits.

The problem occurs in part because the stock market provides much more than the minimum liquidity necessary to create reasonable cash-in capacity for suppliers of long-term capital to corporations. The extra liquidity entices into play a huge supplemental group — speculators (including pension funds and other institutions with staid names) seeking relatively short-term gains.

Our liquid stock market, sheltered by gentle tax laws, has acquired a Jekyll-and-Hyde character and serves not only as an orderly place for transaction of essential economic business but also as a near-ideal gambling casino. In recent years the casino part, with its great wealth and prominence, fascinating denizens and occasional bonanzas, has drawn in ever-increasing cascades of short-term speculation. Current 100-Million-share days bring to mind the words of Keynes as he looked back at 1929:

> *"Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on the whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."*

What, if anything, should be done about these developments? How much legalized gambling should our laws encourage, incident to the process of investing in stocks? These are very difficult questions.

One way to address questions of such difficulty is by the "thought experiment" so beloved by Albert Einstein. Suppose the laws were revised to discourage anything but long-term holding of common stock. Assume, as an example, that the income tax rate on any sort of marketable-common-stock-related gain was 70% for *all* non-underwriting holders, including pension funds and charities, with *no* offsets permitted for losses, unless the holding period was at least five years. Would the country be improved?

Although tinkering would be desirable to prevent fringe inequities, it turns out that such tax law revision would be a good thing.

The revision supposed would drastically reduce stock option trading and make the market for common stocks *less* liquid, but liquidity would remain much better than that available for owners of farms or industrial real estate and would be good enough. Commissions on common stock transactions would be higher, but not greatly higher, and would not impede serious long-term investment.

Investment in common stocks would become a little more like real estate investment, or the investment made when Henry Ford received his grubstake. Investment in newly-issued

common stock and common-stock-related securities like convertible debentures would continue, although the first public issues of formerly private companies would create a less liquid after-market, tending to force prices toward levels which would attract serious buyers planning to hold for a long time. Most expansion of business plant would be financed, as it always has been, by retained corporate earnings and borrowings.

The potentiality for crazy, greedy, speculative stock market orgies would probably be reduced. Such orgies are harmful to a country, have recently occurred in Israel, Kuwait and Hong Kong, and can conceivably occur here, as in 1929 or worse.

The "professional-bad-guy" game, on balance not a good thing, would probably be dampened down to some extent from its present frenzy, and what was left would provide more tax revenue.

Long-term thinking would be more dominant, not only in the stock investment process, but also in the corporate management process, as the whirlpool of speculation, decried by Keynes, was reduced. It is contrary to the national interest to have corporate managers as pre-occupied as they now are with short-term records and temporary stock market effects. So pre-occupied, managers cause corporate action too similar to that of politicians voting to effect outcomes in the next election rather than the next generation.

After anti-common-stock-speculation revision of the income tax law, some portion of the nation's best brain power would be diverted from stock speculation into activities such as creation of more efficient retailing or diesel engines. Accumulators of capital would tend to be a little more in the mold of Edwin Land, David Packard and Jack Nicklaus, whose contributions prevent resentment of their good fortune. Aristotle rightly concluded that power should go to people perceived as deserving power, and improvement in the reputation for quality of society's big winners would be desirable.

There is little to lose by shifting tax burdens to favor by a greater extent long-term instead of short-term investment. The present gross excess of short-term investment, if squeezed out, would not be missed by the overwhelming majority of citizens. Pension and endowment funds could easily adapt to purchasing stocks with the same time horizons now used when purchasing real estate and, in aggregate, would be richer for the change. Stockbrokers

can reasonably be required to join independent truck drivers, unionized air line stewardesses, etc., in adjusting to reduced incomes caused by changes made in the laws to improve the economic system. Moreover, even if a little pro-social activity were eliminated along with more massive anti-social activity, that is no real objection. The problem is like that of the cancer surgeon who wisely uses his knife despite the inevitable destruction of a little good tissue with the bad.

With gambling proclivity entrenched in the culture, it would be unwise to try to eliminate all gambling. But it does not follow that gambling-type activity should be subject to subnormal instead of above-normal income tax rates and be intermixed influentially with the capital development of the country. While gains made in long-term common stock investment should be tax-favored as an inducement to saving and eventual transfer of power, gains made in relatively short-term stock investment, in essence mere gambling-type activity, should either be taxed normally, or better yet, be taxed at above-normal rates.

The rewards and penalties of the Internal Revenue Code channel the energies of the citizenry and have a high moral content as they encourage one kind of activity over another. Recently, Congress, at the request of commodity traders and other special interests, has legislated in a manner exactly opposite from right by imposing on a dollar earned in holding a stock index futures contract for ten minutes a tax rate *lower* than is paid on a dollar earned in farming, teaching or night work as a janitor. To the extent the income tax law differs from norms of social value judgment, it becomes less respected, a serious thing when tax collection depends largely on voluntary compliance. The recent legislation impairs what we need, esteem for the tax law, to enhance what we would be better off without, more trading in stock index futures.

The utility of "thought experiment," for lesser mortals as well as Einstein, lies in its capacity to force acceptance of truths which are counter-intuitive. Counter-intuitive as it may be for traditionalists and "free-enterprise" types, the country would work better if the income tax law were revised to deter the short-term speculation and *reduce* liquidity in the stock market. The truly productive part of "free-enterprise" and the security of its future would thereby be both (1) enhanced by increased emphasis on long-term effects of investment accompanied by diversion of talent from speculation to more

useful work and (2) less likely to be damaged by unsound future legislation attributable to public resentment of after-effects of stock market orgies and wasteful proliferation of "new capitalists" who produce too little for what they get.

1524 WORDS

DRAFT
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The practice of playing the stock market for relatively short-term gains has now reached such a high level that it tends to give a bad name to capitalism, thus threatening the cornucopia of goods and freedoms which only capitalism can provide. The country would be improved by revision of its income tax law to reduce such activity, instead of treating it as a treasured national resource.

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can reasonably be required to join independent truck drivers, unionized air line stewardesses, etc., in adjusting to reduced incomes caused by changes made in the laws to improve the economic system. Moreover, even if a little pro-social activity were eliminated along with more massive anti-social activity, that is no real objection. The problem is like that of the cancer surgeon who wisely uses his knife despite the inevitable destruction of a little good tissue with the bad.

With gambling proclivity entrenched in the culture, it would be unwise to try to eliminate all gambling. But it does not follow that gambling-type activity should be subject to subnormal instead of above-normal income tax rates and be intermixed influentially with the capital development of the country. While gains made in long-term common stock investment should be tax-favored as an inducement to saving and eventual transfer of power, gains made in relatively short-term stock investment, in essence mere gambling-type activity, should either be taxed normally, or better yet, be taxed at above-normal rates.

The rewards and penalties of the Internal Revenue Code channel the energies of the citizenry and have a high moral content as they encourage one kind of activity over another. Recently, Congress, at the request of commodity traders and other special interests, has legislated in a manner exactly opposite from right by imposing on a dollar earned in holding a stock index futures contract for ten minutes a tax rate *lower* than is paid on a dollar earned in farming, teaching or night work as a janitor. To the extent the income tax law differs from norms of social value judgment, it becomes less respected, a serious thing when tax collection depends largely on voluntary compliance. The recent legislation impairs what we need, esteem for the tax law, to enhance what we would be better off without, more trading in stock index futures.

The utility of "thought experiment," for lesser mortals as well as Einstein, lies in its capacity to force acceptance of truths which are counter-intuitive. Counter-intuitive as it may be for traditionalists and "free-enterprise" types, the country would work better if the income tax law were revised to deter the short-term speculation and *reduce* liquidity in the stock market. The truly productive part of "free-enterprise" and the security of its future would thereby be both (1) enhanced by increased emphasis on long-term effects of investment accompanied by diversion of talent from speculation to more

useful work and (2) less likely to be damaged by unsound future legislation attributable to public resentment of after-effects of stock market orgies and wasteful proliferation of "new capitalists" who produce too little for what they get.

1524 WORDS

Resignation of Mutual Savings from US League of Savings Institutions

May 30, 1989

Gentlemen:

This letter is the formal resignation of Mutual Savings and Loan Association from the United States League of Saving Institutions.

Mutual Savings is a subsiduary of Wesco Financial Corporation, listed ASE, and Berkshire Hathaway Inc., listed NYSE, which are no longer willing to be associated with the league.

Mutual Savings does not lightly resign after belonging to the League for many years. But we believe that the League's current lobbying operations are so flawed, indeed disgraceful, that we are not willing to maintain membership.

Our savings and loan industry has now created the largest mess in the history of U.S. financial institutions. While the mess has many causes, which we tried to summarize fairly in our last annual report to stockholders, it was made much worse by (1) constant and successful inhibition over many years, through League lobbying, of proper regulartory response to operations of a minoritry of insured institutions dominated by crooks and fools, (2) Mickey Mouse accounting which made many insured institutions look sounder than they really were, and (3) inadequate levels of real equity capital underlying insured institutions' promises to holders of savings accounts.

It is not unfair to liken the situation now facing Congress to cancer and to liken the League to a significant carcinogenic agent. And, like cancer, our present troubles will recur if Congress lacks the wisdom and courage to excise elements which helped cause the troubles.

Moreover, despite the obvious need to a real legislative reform, involving painful readjustment, the League's recent lobbying efforts regularly resist minimal reform. For instance, the League supports (1) extension of accounting conventions allowing 'goodwill' (in the financial institutions' context translate 'air') to count as capital in relations with regulators and (2) minimization of the amount of real equity capital required as a condition of maintenance of full scale operations relying on federal deposit insurance.

In the face of a national disaster which League lobbying plainly helped cause, the League obdurately persists in prescribing continuation of loose accounting principles, inadequate capital, and, in effect, inadequate management at many insured institutions. The League responds to the savings and loan mess as Exxon would have responded to the oil spill from the Valdez if it had insisted thereafter on liberal use of whiskey by tanker captains.

It would be much better if the League followed the wise example, in another era, of the manufacturer which made a public apology to Congress. Because the League has clearly misled its government for a long time, to the taxpayers' great detriment, a public apology is in order, not redoubled efforts to mislead further.

We know that there is a school of thought that trade associations are to be held to no high standard, that they are supposed to act as the league is acting. In this view, each industry creates a trade association not to proffer truth or reason or normal human courtesy following egregious fault, but merely to furnish self-serving nonsense

and political contributions to counterbalance, in the legislative meilieu, the self-serving nonsense and political contributions of other industries' trade associations. But the evidence is now before us that the type of trade association conduct, when backed as in the League's case by vocal and affluent constituents in every congressional district, has an immense capacity to do harm to the country. Therefore, the League's public duty is to behave in an entirely different way, much as major-league baseball reformed after the "Black Sox" scandal. Moreover, just as client savings institutions are now worse off because of the increased mess caused by League short-sightedness in the past, client institutions will later prove ill-served by the present short-sightedness of the League.

Believing this, Mr. Warren E. Buffett and I are not only causing Mutual Savings to resign from the U.S. League of Savings Institutions; we are also, as one small measure of protest, releasing to the media, for such attention as may ensue, copies of this letter of resignation.

Truly yours,
Charles T. Munger

WESCO FINANCIAL'S CHARLIE MUNGER

"A LESSON ON ELEMENTARY, WORLDLY WISDOM AS IT RELATES TO INVESTMENT MANAGEMENT & BUSINESS."

from a lecture to the students of Professor Guilford Babcock at the University of Southern California Marshall School of Business

from Outstanding Investor Digest's May 5, 1995 Edition

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A particularly astute student of human nature - particularly insofar as it relates to business and investing - Charlie Munger's counsel is highly prized and relied upon by friend and partner Warren Buffett. His insights are equally valued and sought after by more than a few OID subscribers and contributors (and editors).

Therefore, we were very pleased to be allowed to sit in on Munger's lecture at the University of Southern California last year on "investment expertise as a subdivision of elementary, worldly wisdom" and very gratefully acknowledge his generous permission to share it with you.

As always, we highly recommend a very careful reading (and re-reading) of his comments and insights and hope that you find them as valuable as we do:

ALL TOO LITTLE WORLDLY WISDOM
IS DELIVERED BY MODERN EDUCATION.

To be a great stock picker, you need some general education.

Charlie Munger: I'm going to play a minor trick on you today - because the subject of my talk is the art of stock picking as a subdivision of the art of worldly wisdom. That enables me to start talking about worldly wisdom - a much broader topic that interests me because I think all too little of it is delivered by modern educational systems, at least in an effective way.

And therefore, the talk is sort of along the lines that some behaviorist psychologists call Grandma's rule - after the wisdom of Grandma when she said that you have to eat the carrots before you get the dessert.

The carrot part of this talk is about the general subject of worldly wisdom which is a pretty good way to start. After all, the theory of modern education is that you need a general education before you specialize. And I think to some extent, before you're going to be a great stock picker, you need some general education.

So, emphasizing what I sometimes waggishly call remedial worldly wisdom, I'm going to start by waltzing you through a few basic notions.

WITHOUT MODELS FROM MULTIPLE DISCIPLINES,

YOU'LL FAIL IN BUSINESS AND IN LIFE.

Without a latticework of models, you'll fail in school and life.

Munger: What is elementary, worldly wisdom? Well, the first rule is that you can't really know anything if you just remember isolated facts and try and bang 'em back. If the facts don't hang together on a latticework of theory, you don't have them in a usable form.

You've got to have models in your head. And you've got to array your experience - both vicarious and direct - on this latticework of models. You may have noticed students who just try to remember and pound back what is remembered. Well, they fail in school and fail in life. You've got to hang experience on a latticework of models in your head.

Absent enough models, your brain will torture reality.

Munger: What are the models? Well, the first rule is that you've got to have multiple models - because if you just have one or two that you're using, the nature of human psychology is such that you'll torture reality so that it fits your models, or at least you'll think it does. You become the equivalent of a chiropractor who, of course, is the great boob in medicine.

It's like the old saying, "To the man with only a hammer, every problem looks like a nail." And of course, that's the way the chiropractor goes about practicing medicine. But that's a perfectly disastrous way to think and a perfectly disastrous way to operate in the world. So you've got to have multiple models.

And the models have to come from multiple disciplines - because all the wisdom of the world is not to be found in one little academic department. That's why poetry professors, by and large. are so unwise in a worldly sense. They don't have enough models in their heads. So you've got to have models across a fair array of disciplines.

Fortunately, it isn't all that tough....

Munger: You may say, "My God, this is already getting way too tough." But, fortunately, it isn't that tough - because 80 or 90 important models will carry about 90% of the freight in making you a worldly-wise person. And, of those, only a mere handful really carry very heavy freight.

So let's briefly review what kind of models and techniques constitute this basic knowledge that everybody has to have before they proceed to being really good at a narrow art like stock picking.

YOU'RE GIVING A HUGE ADVANTAGE TO OTHERS
IF YOU DON'T LEARN THIS SIMPLE TECHNIQUE.

The great useful model is permutations & combinations.

Munger: First there's mathematics. Obviously, you've got to he able to handle numbers and quantities - basic arithmetic.

And the great useful model, after compound interest, is the elementary math of permutations and combinations. And that was taught in my day in the sophomore year in high school. I suppose by now in great private schools, it's probably down to the eighth grade or so.

It's very simple algebra. And it was all worked out in the course of about one year in correspondence between Pascal and Fermat. They worked it out casually in a series of letters.

Your brain isn't designed to figure it out spontaneously.

Munger: It's not that hard to learn. What is hard is to get so you use it routinely almost everyday of your life. The Fermat/Pascal system is dramatically consonant with the way that the world works. And it's fundamental truth. So you simply have to have the technique.

Many educational institutions - although not nearly enough - have realized this. At Harvard Business School, the great quantitative thing that bonds the first-year class together is what they call decision tree theory. All they do is take high school algebra and apply it to real life problems. And the students love it. They're amazed to find that high school algebra works in life....

By and large. as it works out, people can't naturally and automatically do this. If you understand elementary psychology, the reason they can't is really quite simple: The basic neural network of the brain is there through broad genetic and cultural evolution. And it's not Fermat/Pascal. It uses a very crude, shortcut-type of approximation. It's got elements of Fermat/Pascal in it. However, it's not good.

Without it, you're giving a huge advantage to others....

Munger: So you have to learn in a very usable way this very elementary math and use it routinely in life - just the way if you want to become a golfer, you can't use the natural swing that broad evolution gave you. You have to learn to have a certain grip and swing in a different way to realize your full potential as a golfer.

If you don't get this elementary, but mildly unnatural, mathematics of elementary probability into your repertoire, then you go through a long life like a one-legged man in an ass-kicking contest. You're giving a huge advantage to everybody else.

One of the advantages of a fellow like Buffett, whom I've worked with all these years, is that he automatically thinks in terms of decision trees and the elementary math of permutations and combinations....

NEXT, YOU HAVE TO KNOW ACCOUNTING
- ALONG WITH ITS LIMITATIONS.

Double-entry bookkeeping was a hell of an invention.

Munger: Obviously, you have to know accounting. It's the language of practical business life. It was a very useful thing to deliver to civilization. I've heard it came to civilization through Venice which of course was once the great commercial power in the Mediterranean. However, double-entry bookkeeping was a hell of an invention.

And it's not that hard to understand.

But you have to know accounting's limitations....

Munger: But you have to know enough about it to understand its limitations - because although accounting is the starting place, it's only a crude approximation. And it's not very hard to understand its limitations. For example, everyone can see that you have to more or less just guess at the useful life of a jet airplane or anything like that. Just because you express the depreciation rate in neat numbers doesn't make it anything you really know.

In terms of the limitations of accounting, one of my favorite stories involves a very great businessman named Carl Braun who created the CF Braun Engineering Company. It designed and built oil refineries - which is very hard to do. And Braun would get them to come in on time and not blow up and have efficiencies and so forth. This is a major art.

And Braun, being the thorough Teutonic type that he was, had a number of quirks. And one of them was that he took a look at standard accounting and the way it was applied to building oil refineries and he said, "This is asinine."

So he threw all of his accountants out and he took his engineers and said "Now, we'll devise our own system of accounting to handle this process." And in due time, accounting adopted a lot of Carl Braun's notions. So he was a formidably willful and talented man who demonstrated both the importance of accounting and the importance of knowing its limitations.

AN IRON RULE OF WORLDLY WISDOM:
ALWAYS, ALWAYS, ALWAYS TELL PEOPLE WHY.

Braun's Five W's: Who, what, where, when and why.

Munger: He had another rule, from psychology, which, if you're interested in wisdom, ought to be part of your repertoire - like the elementary mathematics of permutations and combinations.

His rule for all the Braun Company's communications was called the five W's - you had to tell who was going to do what, where, when and why. And if you wrote a letter or directive in the Braun Company telling somebody to do something, and you didn't tell him why, you could get fired. In fact, you would get fired if you did it twice.

If you tell people why, they'll be much more likely to comply.

Munger: You might ask why that is so important? Well, again that's a rule of psychology. Just as you think better if you array knowledge on a bunch of models that are basically answers to the question, why, why, why, if you always tell people why, they'll understand it better, they'll consider it more important, and they'll be more likely to comply. Even if they don't understand your reason, they'll be more likely to comply.

So there's an iron rule that just as you want to start getting worldly wisdom by asking why, why, why in communicating with other people about everything, you want to include why, why, why. Even if it's obvious, it's wise to stick in the why.

ENGINEERING HAS MORE THAN ITS SHARE OF MODELS.
AND THEY'RE THE MOST RELIABLE ONES, AS WELL.

The most reliable models? Engineering models, of course.

Munger: Which models are the most reliable? Well, obviously, the models that come from hard science and engineering are the most reliable models on this Earth. And engineering quality control - at least the guts of it that matters to you and me and people who are not professional engineers - is very much based on the elementary mathematics of Fermat and Pascal:

It costs so much and you get so much less likelihood of it breaking if you spend this much. It's all elementary high school mathematics. And an elaboration of that is what Deming brought to Japan for all of that quality control stuff.

You have to understand normal occurrence distributions.

Munger: I don't think it's necessary for most people to be terribly facile in statistics. For example, I'm not sure that I can even pronounce the Poisson distribution, although I know what it looks like and I know that events and huge aspects of reality end up distributed that way. So I can do a rough calculation.

But if you ask me to work out something involving a Poisson distribution to ten decimal points, I can't sit down and do the math. I'm like a poker player who's learned to play pretty well without mastering Pascal.

And by the way, that works well enough. But you have to understand that bell-shaped curve at least roughly as well as I do.

Engineering has more than its share of powerful models....

Munger: And, of course, the engineering idea of a backup system is a very powerful idea. The engineering idea of breakpoints - that's a very powerful model, too. The notion of a critical mass - that comes out of physics - is a very powerful model.

All of these things have great utility in looking at ordinary reality. And all of this cost-benefit analysis - hell, that's all elementary high school algebra. too. It's just been dolled up a little bit with fancy lingo.

THE HUMAN MIND HAS ENORMOUS POWER,
BUT IT ALSO HAS STANDARD MISFUNCTIONS.

Our brains take shortcuts. So we're subject to manipulation.

Munger: I suppose the next most reliable models are from biology/physiology because, after all, all of us are programmed by our genetic makeup to be much the same.

And then when you get into psychology, of course, it gets very much more complicated. But it's an ungodly important subject if you're going to have any worldly wisdom.

And you can demonstrate that point quite simply: There's not a person in this room viewing the work of a very ordinary professional magician who doesn't see a lot of things happening that aren't happening and not see a lot of things happening that are happening.

And the reason why is that the perceptual apparatus of man has shortcuts in it. The brain cannot have unlimited circuitry. So someone who knows how to take advantage of those shortcuts and cause the brain to miscalculate in certain ways can cause you to see things that aren't there.

Therefore, you must know your brain's limitations.

Munger: Now you get into the cognitive function as distinguished from the perceptual function. And there, you are equally - more than equally in fact - likely to be misled. Again, your brain has a shortage of circuitry and so forth - and it's taking all kinds of little automatic shortcuts.

So when circumstances combine in certain ways - or more commonly, your fellow man starts acting like the magician and manipulates you on purpose by causing your cognitive dysfunction - you're a patsy.

And so just as a man working with a tool has to know its limitations, a man working with his cognitive apparatus has to know its limitations. And this knowledge, by the way, can be used to control and motivate other people....

Very eminent places miseducate people like you and me.

Munger: So the most useful and practical part of psychology - which I personally think can be taught to any intelligent person in a week - is ungodly important. And nobody taught it to me by

the way. I had to learn it later in life, one piece at a time. And it was fairly laborious. It's so elementary though that, when it was all over, I just felt like a total horse's ass.

And yeah, I'd been educated at Cal Tech and the Harvard Law School and so forth. So very eminent places miseducated people like you and me.

Psychology of misjudgment is terribly important to learn.

Munger: The elementary part of psychology - the psychology of misjudgment, as I call it - is a terribly important thing to learn. There are about 20 little principles. And they interact, so it gets slightly complicated. But the guts of it is unbelievably important.

Terribly smart people make totally bonkers mistakes by failing to pay heed to it. In fact, I've done it several times during the last two or three years in a very important way. You never get totally over making silly mistakes.

Man's mind can be manipulated in amazing ways.

Munger: There's another saying that comes from Pascal which I've always considered one of the really accurate observations in the history of thought. Pascal said, "The mind of man at one and the same time is both the glory and the shame of the universe."

And that's exactly right. It has this enormous power. However, it also has these standard misfunctions that often cause it to reach wrong conclusions. It also makes man extraordinarily subject to manipulation by others. For example, roughly half of the army of Adolf Hitler was composed of believing Catholics. Given enough clever psychological manipulation, what human beings will do is quite interesting.

Consider the real interests and the psychological factors....

Munger: Personally, I've gotten so that I now use a kind of two-track analysis. First, what are the factors that really govern the interests involved, rationally considered? And second, what are the subconscious influences where the brain at a subconscious level is automatically doing these things - which by and large are useful, but which often misfunction.

One approach is rationality - the way you'd work out a bridge problem: by evaluating the real interests, the real probabilities and so forth. And the other is to evaluate the psychological factors that cause subconscious conclusions - many of which are wrong.

ORGANISMS, PEOPLE & COMPANIES WHO SPECIALIZE
CAN GET TERRIBLY GOOD IN THEIR LITTLE NICHE.

Like it or not, the economy is a lot like an ecosystem.

Munger: Now we come to another somewhat less reliable form of human wisdom - microeconomics. And here, I find it quite useful to think of a free market economy - or partly free market economy - as sort of the equivalent of an ecosystem....

This is a very unfashionable way of thinking because early in the days after Darwin came along, people like the robber barons assumed that the doctrine of the survival of the fittest authenticated them as deserving power - you know, "I'm the richest. Therefore, I'm the best. God's in his heaven, etc."

And that reaction of the robber barons was so irritating to people that it made it unfashionable to think of an economy as an ecosystem. But the truth is that it is a lot like an ecosystem. And you get many of the same results.

In nature and in business, specialization is key.

Munger: Just as in an ecosystem, people who narrowly specialize can get terribly good at occupying some little niche. Just as animals flourish in niches, similarly, people who specialize in the business world - and get very good because they specialize - frequently find good economics that they wouldn't get any other way.

Advantages of scale are ungodly important.

Munger: And once we get into microeconomics, we get into the concept of advantages of scale. Now we're getting closer to investment analysis - because in terms of which businesses succeed and which businesses fail, advantages of scale are ungodly important.

For example, one great advantage of scale taught in all of the business schools of the world is cost reductions along the so-called experience curve. Just doing something complicated in more and more volume enables human beings, who are trying to improve and are motivated by the incentives of capitalism, to do it more and more efficiently.

The very nature of things is that if you get a whole lot of volume through your joint, you get better at processing that volume. That's an enormous advantage. And it has a lot to do with which businesses succeed and fail....

AND THERE ARE OTHER ECONOMIES: GEOMETRIC, ADVERTISING, INFORMATION, EVEN PSYCHOLOGICAL.

There are even geometric economies of scale.

Munger: Let's go through a list - albeit an incomplete one of possible advantages of scale. Some come from simple geometry. If you're building a great circular tank, obviously as you build it bigger, the amount of steel you use in the surface goes up with the square and the cubic volume goes up with the cube. So as you increase the dimensions, you can hold a lot more volume per unit area of steel.

And there are all kinds of things like that where the simple geometry - the simple reality - gives you an advantage of scale.

For example, network TV advertising made the rich richer.

Munger: For example, you can get advantages of scale from TV advertising. When TV advertising first arrived - when talking color pictures first came into our living rooms - it was an unbelievably powerful thing. And in the early days, we had three networks that had whatever it was - say 90% of the audience.

Well, if you were Proctor & Gamble, you could afford to use this new method of advertising. You could afford the very expensive cost of network television because you were selling so damn many cans and bottles. Some little guy couldn't. And there was no way of buying it in part. Therefore, he couldn't use it. In effect, if you didn't have a big volume, you couldn't use network TV advertising - which was the most effective technique.

So when TV came in, the branded companies that were already big got a huge tail wind. Indeed, they prospered and prospered and prospered until some of them got fat and foolish. which happens with prosperity - at least to some people....

The informational advantage of brands is hard to beat.

Munger: And your advantage of scale can be an informational advantage. If I go to some remote place, I may see Wrigley chewing gum alongside Glotz's chewing gum. Well, I know that Wrigley is a satisfactory product, whereas I don't know anything about Glotz's. So if one is $.40 and the other is $.30, am I going to take something I don't know and put it in my mouth - which is a pretty personal place, after all - for a lousy dime?

So, in effect, Wrigley, simply by being so well known, has advantages of scale - what you might call an informational advantage.

Everyone is influenced by what others do and approve.

Munger: Another advantage of scale comes from psychology. The psychologists use the term "social proof". We are all influenced - subconsciously and to some extent consciously - by what we see others do and approve. Therefore, if everybody's buying something, we think it's better. We don't like to be the one guy who's out of step.

Again, some of this is at a subconscious level and some of it isn't. Sometimes, we consciously and rationally think, "Gee, I don't know much about this. They know more than I do. Therefore, why shouldn't I follow them?"

All told, your advantages can add up to one tough moat.

Munger: The social proof phenomenon which comes right out of psychology gives huge advantages to scale - for example, with very wide distribution, which of course is hard to get. One advantage of Coca-Cola is that it's available almost everywhere in the world.

Well, suppose you have a little soft drink. Exactly how do you make it available all over the Earth? The worldwide distribution setup - which is slowly won by a big enterprise - gets to be a huge advantage.... And if you think about it, once you get enough advantages of that type, it can become very hard for anybody to dislodge you.

THINGS TEND TOWARD WINNER TAKE ALL.
THEREFORE, IT PAYS TO BE #1, #2 OR OUT.

Things tend to cascade toward winner-take-all.

Munger: There's another kind of advantage to scale. In some businesses, the very nature of things is to sort of cascade toward the overwhelming dominance of one firm. The most obvious one is daily newspapers. There's practically no city left in the U.S., aside from a few very big ones, where there's more than one daily newspaper.

And again, that's a scale thing. Once I get most of the circulation, I get most of the advertising. And once I get most of the advertising and circulation, why would anyone want the thinner paper with less information in it? So it tends to cascade to a winner-take-all situation. And that's a separate form of the advantages of scale phenomenon.

Similarly, all these huge advantages of scale allow greater specialization within the firm. Therefore, each person can be better at what he does.

It's not irrational to insist on being #1 or #2 or out.

Munger: And these advantages of scale are so great, for example, that when Jack Welch came into General Electric, he just said, "To hell with it. We're either going to be #1 or #2 in every field we're in or we're going to be out. I don't care how many people I have to fire and what I have to sell. We're going to be #1 or #2 or out."

That was a very tough-minded thing to do, but I think it was a very correct decision if you're thinking about maximizing shareholder wealth. And I don't think it's a bad thing to do for a civilization either, because I think that General Electric is stronger for having Jack Welch there.

HOWEVER, BIGGER ISN'T ALWAYS BETTER -
THERE ARE ALSO DISADVANTAGES OF SCALE.

Bigger isn't always better. Sometimes, it's just the reverse....

Munger: And there are also disadvantages of scale. For example, we - by which I mean Berkshire Hathaway - are the largest shareholder in Capital Cities/ABC. And we had trade publications there that got murdered - where our competitors beat us. And the way they beat us was by going to a narrower specialization.

We'd have a travel magazine for business travel. So somebody would create one which was addressed solely at corporate travel departments. Like an ecosystem, you're getting a narrower and narrower specialization.

Well, they got much more efficient. They could tell more to the guys who ran corporate travel departments. Plus, they didn't have to waste the ink and paper mailing out stuff that corporate travel departments weren't interested in reading. It was a more efficient system. And they beat our brains out as we relied on our broader magazine.

That's what happened to The Saturday Evening Post and all those things. They're gone. What we have now is Motorcross - which is read by a bunch of nuts who like to participate in tournaments where they turn somersaults on their motorcycles. But they care about it. For them, it's the principal purpose of life. A magazine called Motorcross is a total necessity to those people. And its profit margins would make you salivate.

Just think of how narrowcast that kind of publishing is. So occasionally, scaling down and intensifying gives you the big advantage. Bigger is not always better.

Another defect of scale - flush, fat, stupid bureaucracy.

Munger: The great defect of scale, of course, which makes the game interesting - so that the big people don't always win - is that as you get big, you get the bureaucracy. And with the bureaucracy comes the territoriality - which is again grounded in human nature.

And the incentives are perverse. For example, if you worked for AT&T in my day, it was a great bureaucracy. Who in the hell was really thinking about the shareholder or anything else? And in a bureaucracy, you think the work is done when it goes out of your in-basket into somebody's else's in-basket. But, of course, it isn't. It's not done until AT&T delivers what it's supposed to deliver. So you get big, fat, dumb, unmotivated bureaucracies.

Bureaucracy's a terrible problem - especially in government.

Munger: They also tend to become somewhat corrupt. In other words, if I've got a department and you've got a department and we kind of share power running this thing, there's sort of an unwritten rule: "If you won't bother me, I won't bother you and we're both happy." So you get layers of management and associated costs that nobody needs. Then, while people are justifying all these layers. it takes forever to get anything done. They're too slow to make decisions and nimbler people run circles around them.

The constant curse of scale is that it leads to big, dumb bureaucracy - which, of course, reaches its highest and worst form in government where the incentives are really awful. That doesn't mean we don't need governments - because we do. But it's a terrible problem to get big bureaucracies to behave.

Some companies deal with bureaucracies well: e.g., GE.

Munger: So people go to stratagems. They create little decentralized units and fancy motivation and training programs. For example, for a big company, General Electric has fought bureaucracy with amazing skill. But that's because they have a combination of a genius and a fanatic running it. And they put him in young enough so he gets a long run. Of course, that's Jack Welch.

Others don't deal with it very well at all....

Munger: But bureaucracy is terrible.... And as things get very powerful and very big, you can get some really dysfunctional behavior. Look at Westinghouse. They blew billions of dollars on a bunch of dumb loans to real estate developers. They put some guy who'd come up by some career path - I don't know exactly what it was, but it could have been refrigerators or something - and all of a sudden, he's loaning money to real estate developers building hotels. It's a very unequal contest. And in due time, they lost all those billions of dollars.

You get a lot of dysfunction in a big, fat, happy place.

Munger: CBS provides an interesting example of another rule of psychology - namely, Pavlovian association. If people tell you what you really don't want to hear - what's unpleasant - there's an almost automatic reaction of antipathy. You have to train yourself out of it. It isn't foredestined that you have to be this way. But you will tend to be this way if you don't think about it.

Television was dominated by one network - CBS - in its early days. And Paley was a god. But he didn't like to hear what be didn't like to hear, And people soon learned that. So they told Paley only what he liked to hear, Therefore, he was soon living in a little cocoon of unreality and everything else was corrupt - although it was a great business,

So the idiocy that crept into the system was carried along by this huge tide. It was a Mad Hatter's tea party the last ten years under Bill Paley.

And that is not the only example by any means. You can get severe misfunction in the high ranks of business, And of course, if you're investing, it can make a hell of a lot of difference. If you take all the acquisitions that CBS made under Paley, after the acquisition of the network itself, with all his dumb advisors - his investment bankers, management consultants and so forth who were getting paid very handsomely - it was absolutely terrible.

For example, he gave something like 20% of CBS to the Dumont Company for a television set manufacturer which was destined to go broke. I think it lasted all of two or three years or something like that. So very soon after he'd issued all of that stock, Dumont was history. You get

a lot of dysfunction in a big fat, powerful place where no one will bring unwelcome reality to the boss.

An everlasting battle between the pros and cons of size.

Munger: So life is an everlasting battle between those two forces - to get these advantages of scale on one side and a tendency to get a lot like the U.S. Agriculture Department on the other side - where they just sit around and so forth. I don't know exactly what they do. However, I do know that they do very little useful work,

A CASE STUDY IN ECONOMIES VS. DISECONOMICS
- WAL-MART VERSUS SEARS, ROEBUCK.

A chain store can be a fantastic enterprise.

Munger: On the subject of advantages of economies of scale, I find chain stores quite interesting. Just think about it. The concept of a chain store was a fascinating invention. You get this huge purchasing power - which means that you have lower merchandise costs. You get a whole bunch of little laboratories out there in which you can conduct experiments. And you get specialization.

If one little guy is trying to buy across 27 different merchandise categories influenced by traveling salesmen, he's going to make a lot of dumb decisions. But if your buying is done in headquarters for a huge bunch of stores, you can get very bright people that know a lot about refrigerators and so forth to do the buying.

The reverse is demonstrated by the little store where one guy is doing all the buying. It's like the old story about the little store with salt all over its walls. And a stranger comes in and says to the store owner, "You must sell a lot of salt." And he replies, "No, I don't. But you should see the guy who sells me salt."

So there are huge purchasing advantages. And then there are the slick systems of forcing everyone to do what works. So a chain store can be a fantastic enterprise.

Sam Walton played the game harder and better than anyone.

Munger: It's quite interesting to think about Wal-Mart starting from a single store in Bentonville, Arkansas - against Sears Roebuck with its name, reputation and all of its billions. How does a guy in Bentonville, Arkansas with no money blow right by Sears, Roebuck? And he does it in his own lifetime - in fact, during his own late lifetime because he was already pretty old by the time he started out with one little store....

He played the chain store game harder and better than anyone else. Walton invented practically nothing. But he copied everything anybody else ever did that was smart - and he did it with more fanaticism and better employee manipulation. So he just blew right by them all.

And he had a very shrewd strategy....

Munger: He also had a very interesting competitive strategy in the early days. He was like a prize fighter who wanted a great record so he could be in the finals and make a big TV hit. So what did he do? He went out and fought 42 palookas. Right? And the result was knockout, knockout, knockout - 42 times.

Walton, being as shrewd as he was, basically broke other small town merchants in the early days. With his more efficient system, he might not have been able to tackle some titan head-on at the time. But with his better system, he could sure as hell destroy those small town merchants. And he went around doing it time after time after time. Then, as he got bigger, he started destroying the big boys.

Well, that was a very, very shrewd strategy.

I believe that the world is better for having Wal-Mart.

Munger: You can say, "Is this a nice way to behave?" Well, capitalism is a pretty brutal place. But I personally think that the world is better for having Wal-Mart. I mean you can idealize small town life. But I've spent a fair amount of time in small towns. And let me tell you - you shouldn't get too idealistic about all those businesses he destroyed.

Plus, a lot of people who work at Wal-Mart are very high grade, bouncy people who are raising nice children. I have no feeling that an inferior culture destroyed a superior culture. I think that is nothing more than nostalgia and delusion. But, at any rate. it's an interesting model of how the scale of things and fanaticism combine to be very powerful.

Sears was a classic case study in diseconomics.

Munger: And it's also an interesting model on the other side - how with all its great advantages, the disadvantages of bureaucracy did such terrible damage to Sears, Roebuck. Sears had layers and layers of people it didn't need. It was very bureaucratic. It was slow to think. And there was an established way of thinking. If you poked your head up with a new thought, the system kind of turned against you. It was everything in the way of a dysfunctional big bureaucracy that you would expect.

In all fairness, there was also much that was good about it. But it just wasn't as lean and mean and shrewd and effective as Sam Walton. And, in due time, all their advantages of scale were not enough to prevent Sears from losing heavily to Wal-Mart and other similar retailers.

A MODEL WE'VE HAD TROUBLE WITH -
ANTICIPATING COMPETITION AND ITS EFFECTS.

In some markets, no one makes out. In others, everyone does.

Munger: Here's a model that we've had trouble with. Maybe you'll be able to figure it out better. Many markets get down to two or three big competitors - or five or six. And in some of those markets, nobody makes any money to speak of. But in others, everybody does very well.

Over the years, we've tried to figure out why the competition in some markets gets sort of rational from the investor's point of view so that the shareholders do well, and in other markets, there's destructive competition that destroys shareholder wealth.

It's easy to understand why air travel is so unprofitable....

Munger: If it's a pure commodity like airline seats, you can understand why no one makes any money. As we sit here, just think of what airlines have given to the world - safe travel. greater experience, time with your loved ones, you name it. Yet, the net amount of money that's been made by the shareholders of airlines since Kitty Hawk, is now a negative figure - a substantial negative figure. Competition was so intense that, once it was unleashed by deregulation, it ravaged shareholder wealth in the airline business.

But why is the cereal business so profitable?

Munger: Yet, in other fields - like cereals, for example - almost all the big boys make out. If you're some kind of a medium grade cereal maker, you might make 15% on your capital. And if you're really good. you might make 40%. But why are cereals so profitable - despite the fact that it looks to me like they're competing like crazy with promotions, coupons and everything else? I don't fully understand it.

Obviously, there's a brand identity factor in cereals that doesn't exist in airlines. That must be the main factor that accounts for it.

Maybe it boils down to individual psychology....

Munger: And maybe the cereal makers by and large have learned to be less crazy about fighting for market share - because if you get even one person who's hell-bent on gaining market share.... For example, if I were Kellogg and I decided that I had to have 60% of the market, I think I could take most of the profit out of cereals. I'd ruin Kellogg in the process. But I think I could do it.

In some businesses, the participants behave like a demented Kellogg. In other businesses, they don't. Unfortunately, I do not have a perfect model for predicting how that's going to happen.

For example, if you look around at bottler markets, you'll find many markets where bottlers of Pepsi and Coke both make a lot of money and many others where they destroy most of the profitability of the two franchises. That must get down to the peculiarities of individual adjustment to market capitalism. I think you'd have to know the people involved to fully understand what was happening.

A FEW WORDS ON PATENTS,

TRADEMARKS AND FRANCHISES.

Patents haven't made people much money - until recently.

Munger: In microeconomics, of course, you've got the concept of patents. trademarks, exclusive franchises and so forth. Patents are quite interesting. When I was young, I think more money went into patents than came out. Judges tended to throw them out - based on arguments about what was really invented and what relied on prior art. That isn't altogether clear.

But they changed that. They didn't change the laws. They just changed the administration - so that it all goes to one patent court. And that court is now very much more pro-patent. So I think people are now starting to make a lot of money out of owning patents.

But trademarks and franchises have always been great.

Munger: Trademarks, of course, have always made people a lot of money. A trademark system is a wonderful thing for a big operation if it's well known.

The exclusive franchise can also be wonderful. If there were only three television channels awarded in a big city and you owned one of them, there were only so many hours a day that you could be on. So you had a natural position in an oligopoly in the pre-cable days.

And if you get the franchise for the only food stand in an airport, you have a captive clientele and you have a small monopoly of a sort.

A BASIC LESSON OFTEN FORGOTTEN:
NEW TECHNOLOGY CAN KILL YOU.

You have to discern when technology will help and hurt.

Munger: The great lesson in microeconomics is to discriminate between when technology is going to help you and when it's going to kill you. And most people do not get this straight in their heads. But a fellow like Buffett does.

For example, when we were in the textile business, which is a terrible commodity business, we were making low-end textiles - which are a real commodity product. And one day, the people came to Warren and said, "They've invented a new loom that we think will do twice as much work as our old ones."

And Warren said, "Gee, I hope this doesn't work - because if it does, I'm going to close the mill." And he meant it.

Advances in commodity businesses go to buyers alone.

Munger: What was he thinking? He was thinking, "It's a lousy business. We're earning substandard returns and keeping it open just to be nice to the elderly workers. But we're not going to put huge amounts of new capital into a lousy business."

And he knew that the huge productivity increases that would come from a better machine introduced into the production of a commodity product would all go to the benefit of the buyers of the textiles. Nothing was going to stick to our ribs as owners.

That's such an obvious concept - that there are all kinds of wonderful new inventions that give you nothing as owners except the opportunity to spend a lot more money in a business that's still going to be lousy. The money still won't come to you. All of the advantages from great improvements are going to flow through to the customers.

The newspaper business is another matter altogether....

Munger: Conversely, if you own the only newspaper in Oshkosh and they were to invent more efficient ways of composing the whole newspaper, then when you got rid of the old technology and got new fancy computers and so forth, all of the savings would come right through to the bottom line.

A three-year payback often means a 4% per year return.

Munger: In all cases, the people who sell the machinery - and, by and large, even the internal bureaucrats urging you to buy the equipment - show you projections with the amount you'll save at current prices with the new technology. However, they don't do the second step of the analysis - which is to determine how much is going to stay home and how much is just going to flow through to the customer. I've never seen a single projection incorporating that second step in my life. And I see them all the time. Rather, they always read: "This capital outlay will save you so much money that it will pay for itself in three years."

So you keep buying things that will pay for themselves in three years. And after 20 years of doing it, somehow you've earned a return of only about 4% per annum. That's the textile business.

And it isn't that the machines weren't better. It's just that the savings didn't go to you. The cost reductions came through all right. But the benefit of the cost reductions didn't go to the guy who bought the equipment. It's such a simple idea. It's so basic. And yet it's so often forgotten.

THE NATIONAL CASH REGISTER MODEL
IS EXACTLY WHAT YOU'RE LOOKING FOR.

Early birds have huge advantages....

Munger: Then there's another model from microeconomics which I find very interesting. When technology moves as fast as it does in a civilization like ours, you get a phenomenon which I call

competitive destruction. You know, you have the finest buggy whip factory and all of a sudden in comes this little horseless carriage. And before too many years go by, your buggy whip business is dead. You either get into a different business or you're dead - you're destroyed. It happens again and again and again.

And when these new businesses come in, there are huge advantages for the early birds. And when you're an early bird, there's a model that I call "surfing" - when a surfer gets up and catches the wave and just stays there, he can go a long, long time. But if he gets off the wave, he becomes mired in shallows....

But people get long runs when they're right on the edge of the wave whether it's Microsoft or Intel or all kinds of people, including National Cash Register in the early days.

National Cash Register was a lead pipe cinch....

Munger: The cash register was one of the great contributions to civilization. It's a wonderful story. Patterson was a small retail merchant who didn't make any money. One day, somebody sold him a crude cash register which he put into his retail operation. And it instantly changed from losing money to earning a profit because it made it so much harder for the employees to steal....

But Patterson, having the kind of mind that he did, didn't think, "Oh, good for my retail business." He thought, "I'm going into the cash register business." And, of course, he created National Cash Register.

And he "surfed". He got the best distribution system, the biggest collection of patents and the best of everything. He was a fanatic about everything important as the technology developed. I have in my files an early National Cash Register Company report in which Patterson described his methods and objectives. And a well-educated orangutan could see that buying into partnership with Patterson in those early days, given his notions about the cash register business, was a total 100% cinch.

And, of course, that's exactly what an investor should be looking for. In a long life, you can expect to profit heavily from at least a few of those opportunities if you develop the wisdom and will to seize them. At any rate, "surfing" is a very powerful model.

FIGURE OUT WHERE YOU HAVE AN EDGE
THEN, PLAY THERE AND ONLY THERE.

If we don't believe we have an advantage, we don't play.

Munger: However, Berkshire Hathaway, by and large, does not invest in these people that are "surfing" on complicated technology. After all, we're cranky and idiosyncratic - as you may have noticed.

And Warren and I don't feel like we have any great advantage in the high-tech sector. In fact, we feel like we're at a big disadvantage in trying to understand the nature of technical developments in software, computer chips or what have you. So we tend to avoid that stuff, based on our personal inadequacies.

Figure out where you have an edge - and stay there.

Munger: Again, that is a very, very powerful idea. Every person is going to have a circle of competence. And it's going to be very hard to advance that circle. If I had to make my living as a musician.... I can't even think of a level low enough to describe where I would be sorted out to if music were the measuring standard of the civilization.

So you have to figure out what your own aptitudes are. If you play games where other people have the aptitudes and you don't, you're going to lose. And that's as close to certain as any prediction that you can make. You have to figure out where you've got an edge. And you've got to play within your own circle of competence.

Life is much like trying to be a good plumbing contractor.

Munger: If you want to be the best tennis player in the world, you may start out trying and soon find out that it's hopeless - that other people blow right by you. However, if you want to become the best plumbing contractor in Bemidji, that is probably doable by two-thirds of you. It takes a will. It takes the intelligence. But after a while, you'd gradually know all about the plumbing business in Bemidji and master the art. That is an attainable objective, given enough discipline. And people who could never win a chess tournament or stand in center court in a respectable tennis tournament can rise quite high in life by slowly developing a circle of competence - which results partly from what they were born with and partly from what they slowly develop through work.

So some edges can be acquired. And the game of life to some extent for most of us is trying to be something like a good plumbing contractor in Bemidji. Very few of us are chosen to win the world's chess tournaments.

[Editor's note: Munger's comments remind your editor of Buffett's comments in John Train's The Money Masters. Buffett asks Train, "How do you beat Bobby Fisher?" Answer: "Play him in anything but chess."]

One person's garbage is another's treasure.

Munger: Some of you may find opportunities "surfing" along in the new high-tech fields - the Intels, the Microsofts and so on. The fact that we don't think we're very good at it and have pretty well stayed out of it doesn't mean that it's irrational for you to do it.

TO A MAN WITH PROFICIENCY IN MATH,
EFFICIENT MARKET THEORY LOOKS LIKE A NAIL.

On to dessert - the selection of common stocks....

Munger: Well, so much for the basic microeconomic models, a little bit of psychology, a little bit of mathematics, helping create what I call the general substructure of worldly wisdom. Now, if you want to go on from carrots to dessert, I'll turn to stock picking - trying to draw on this general worldly wisdom as we go.

I don't want to get into emerging markets, bond arbitrage and so forth. I'm talking about nothing but plain vanilla stock picking. That, believe me, is complicated enough. And I'm talking about common stock picking.

Do as I do, not as I say....

Munger: The first question is, "What is the nature of the stock market?" And that gets you directly to this efficient market theory that got to be the rage - a total rage - long after I graduated from law school.

And it's rather interesting because one of the greatest economists of the world is a substantial shareholder in Berkshire Hathaway and has been from the very early days after Buffett was in control. His textbook always taught that the stock market was perfectly efficient and that nobody could beat it. But his own money went into Berkshire and made him wealthy. So. like Pascal in his famous wager, he hedged his bet.

The iron rule of life: Only 20% of us can be in the top 5th.

Munger: Is the stock market so efficient that people can't beat it? Well, the efficient market theory is obviously roughly right - meaning that markets are quite efficient and it's quite hard for anybody to beat the market by significant margins as a stock picker by just being intelligent and working in a disciplined way.

Indeed, the average result has to be the average result. By definition, everybody can't beat the market. As I always say, the iron rule of life is that only 20% of the people can be in the top fifth. That's just the way it is. So the answer is that it's partly efficient and partly inefficient.

Efficient market theory is seductive. Only it's not true....

Munger: And, by the way, I have a name for people who went to the extreme efficient market theory - which is "bonkers". It was an intellectually consistent theory that enabled them to do pretty mathematics. So I understand its seductiveness to people with large mathematical gifts. It just had a difficulty in that the fundamental assumption did not tie properly to reality.

Again, to the man with a hammer, every problem looks like a nail. If you're good at manipulating higher mathematics in a consistent way, why not make an assumption which enables you to use your tool?

BETTING ON HORSES AND PICKING STOCKS
HAVE MORE THAN A LITTLE IN COMMON.

Odds on horses and stocks are set by the market.

Munger: The model I like - to sort of simplify the notion of what goes on in a market for common stocks - is the pari-mutuel system at the race track. If you stop to think about it, a pari-mutuel system is a market. Everybody goes there and bets and the odds change based on what's bet. That's what happens in the stock market.

Any damn fool can see that a horse carrying a light weight with a wonderful win rate and a good post position etc., etc. is way more likely to win than a horse with a terrible record and extra weight and so on and so on. But if you look at the damn odds. the bad horse pays 100 to 1, whereas the good horse pays 3 to 2. Then it's not clear which is statistically the best bet using the mathematics of Fermat and Pascal. The prices have changed in such a way that it's very hard to beat the system.

And then the track is taking 17% off the top. So not only do you have to outwit all the other betters, but you've got to outwit them by such a big margin that on average, you can afford to take 17% of your gross bets off the top and give it to the house before the rest of your money can be put to work.

Believe it or not, some people make money betting horses.

Munger: Given those mathematics, is it possible to beat the horses only using one's intelligence? Intelligence should give some edge, because lots of people who don't know anything go out and bet lucky numbers and so forth. Therefore, somebody who really thinks about nothing but horse performance and is shrewd and mathematical could have a very considerable edge, in the absence of the frictional cost caused by the house take.

Unfortunately, what a shrewd horseplayer's edge does in most cases is to reduce his average loss over a season of betting from the 17% that he would lose if he got the average result to maybe 10%. However, there are actually a few people who can beat the game after paying the full 17%.

I used to play poker when I was young with a guy who made a substantial living doing nothing but bet harness races.... Now. harness racing is a relatively inefficient market. You don't have the depth of intelligence betting on harness races that you do on regular races. What my poker pal would do was to think about harness races as his main profession. And he would bet only occasionally when he saw some mispriced bet available. And by doing that, after paying the full handle to the house - which I presume was around 17% - he made a substantial living.

You have to say that's rare. However, the market was not perfectly efficient. And if it weren't for that big 17% handle, lots of people would regularly be beating lots of other people at the horse races. It's efficient, yes. But it's not perfectly efficient. And with enough shrewdness and fanaticism, some people will get better results than others.

It ain't easy, but it's possible, to outperform in stocks, too.

Munger: The stock market is the same way - except that the house handle is so much lower. If you take transaction costs - the spread between the bid and the ask plus the commissions - and if you don't trade too actively, you're talking about fairly low transaction costs. So that with enough fanaticism and enough discipline, some of the shrewd people are going to get way better results than average in the nature of things.

It is not a bit easy. And, of course, 50% will end up in the bottom half and 70% will end up in the bottom 70%. But some people will have an advantage. And in a fairly low transaction cost operation, they will get better than average results in stock picking.

What works betting horses also works for stock picking.

Munger: How do you get to be one of those who is a winner - in a relative sense - instead of a loser?

Here again, look at the pari-mutuel system. I had dinner last night by absolute accident with the president of Santa Anita. He says that there are two or three betters who have a credit arrangement with them, now that they have off-track betting, who are actually beating the house. They're sending money out net after the full handle - a lot of it to Las Vegas, by the way - to people who are actually winning slightly, net, after paying the full handle. They're that shrewd about something with as much unpredictability as horse racing.

And the one thing that all those winning betters in the whole history of people who've beaten the pari-mutuel system have is quite simple. They bet very seldom.

Winners bet big when they have the odds - otherwise, never.

Munger: It's not given to human beings to have such talent that they can just know everything about everything all the time. But it is given to human beings who work hard at it - who look and sift the world for a mispriced bet - that they can occasionally find one.

And the wise ones bet heavily when the world offers them that opportunity. They bet big when they have the odds. And the rest of the time, they don't. It's just that simple.

AS USUAL, IN HUMAN AFFAIRS
WHAT WINS ARE INCENTIVES.

It's obvious to us. And yet nobody operates that way.

Munger: That is a very simple concept. And to me it's obviously right - based on experience not only from the pari-mutuel system, but everywhere else.

And yet, in investment management, practically nobody operates that way. We operate that way - I'm talking about Buffett and Munger. And we're not alone in the world. But a huge majority of people have some other crazy construct in their heads. And instead of waiting for a near cinch and loading up, they apparently ascribe to the theory that if they work a little harder or hire more business school students, they'll come to know everything about everything all the time.

To me, that's totally insane. The way to win is to work, work, work, work and hope to have a few insights.

Most of Berkshire's billions came from a handful of ideas.

Munger: How many insights do you need? Well, I'd argue that you don't need many in a lifetime. If you look at Berkshire Hathaway and all of its accumulated billions, the top ten insights account for most of it. And that's with a very brilliant man - Warren's a lot more able than I am and very disciplined - devoting his lifetime to it. I don't mean to say that he's only had ten insights. I'm just saying that most of the money came from ten insights.

So you can get very remarkable investment results if you think more like a winning pari-mutuel player. Just think of it as a heavy odds against game full of bullshit and craziness with an occasional mispriced something or other. And you're probably not going to be smart enough to find thousands in a lifetime. And when you get a few, you really load up. It's just that simple.

A simple but powerful way to improve your results....

Munger: When Warren lectures at business schools, he says, "I could improve your ultimate financial welfare by giving you a ticket with only 20 slots in it so that you had 20 punches - representing all the investments that you got to make in a lifetime. And once you'd punched through the card, you couldn't make any more investments at all."

He says, "Under those rules, you'd really think carefully about what you did and you'd be forced to load up on what you'd really thought about. So you'd do so much better."

As long as clients buy salt, investment managers will sell it.

Munger: Again, this is a concept that seems perfectly obvious to me. And to Warren, it seems perfectly obvious. But this is one of the very few business classes in the U.S. where anybody will be saying so. It just isn't the conventional wisdom.

To me, it's obvious that the winner has to bet very selectively. It's been obvious to me since very early in life. I don't know why its not obvious to very many other people.

I think the reason why we got into such idiocy in investment management is best illustrated by a story that I tell about the guy who sold fishing tackle. I asked him, "My God, they're purple and green. Do fish really take these lures?" And he said, "Mister, I don't sell to fish."

Investment managers are in the position of that fishing tackle salesman. They're like the guy who was selling salt to the guy who already had too much salt. And as long as the guy will buy salt, why they'll sell salt. But that isn't what ordinarily works for the buyer of investment advice.

As usual, in human affairs, what wins are incentives.

Munger: If you invested Berkshire Hathaway-style, it would be hard to get paid as an investment manager as well as they're currently paid - because you'd be holding a block of Wal-Mart and a block of Coca-Cola and a block of something else. You'd be sitting on your ass. And the client would be getting rich. And, after a while, the client would think, "Why am I paying this guy half a percent a year on my wonderful passive holdings?"

So what makes sense for the investor is different from what makes sense for the manager. And, as usual in human affairs, what determines the behavior are incentives for the decision maker,

Getting the incentives right is a very, very important lesson.

Munger: From all business, my favorite case on incentives is Federal Express. The heart and soul of their system - which creates the integrity of the product - is having all their airplanes come to one place in the middle of the night and shift all the packages from plane to plane. If there are delays, the whole operation can't deliver a product full of integrity to Federal Express customers.

And it was always screwed up. They could never get it done on time. They tried everything - moral suasion, threats, you name it. And nothing worked.

Finally, somebody got the idea to pay all these people not so much an hour, but so much a shift - and when it's all done, they can all go home. Well, their problems cleared up overnight.

So getting the incentives right is a very, very important lesson. It was not obvious to Federal Express what the solution was. But maybe now, it will hereafter more often be obvious to you.

IF SECTOR ROTATION IS VERY LUCRATIVE,
WE'VE NEVER SEEN THE EVIDENCE.

Once you factor in the odds, the market isn't easy to beat.

Munger: All right, we've now recognized that the market is efficient as a pari-mutuel system is efficient - with the favorite more likely than the long shot to do well in racing, but not necessarily give any betting advantage to those that bet on the favorite.

In the stock market, some railroad that's beset by better competitors and tough unions may be available at one-third of its book value. In contrast, IBM in its heyday might be selling at 6 times book value. So it's just like the pari-mutuel system. Any damn fool could plainly see that IBM had better business prospects than the railroad. But once you put the price into the formula, it

wasn't so clear anymore what was going to work best for a buyer choosing between the stocks. So it's a lot like a pari-mutuel system. And, therefore, it gets very hard to beat.

I know of no really rich "sector rotators"....

Munger: What style should the investor use as a picker of common stocks in order to try to beat the market - in other words, to get an above average long-term result? A standard technique that appeals to a lot of people is called "sector rotation". You simply figure out when oils are going to outperform retailers, etc.. etc., etc. You just kind of flit around being in the hot sector of the market making better choices than other people. And presumably, over a long period of time, you get ahead.

However, I know of no really rich sector rotator. Maybe some people can do it. I'm not saying they can't. All I know is that all the people I know who got rich - and I know a lot of them - did not do it that way.

RICH OR POOR, IT'S GOOD TO HAVE
A HUGE MARGIN OF SAFETY.

A significant discount = more upside + a margin of safety.

Munger: The second basic approach is the one that Ben Graham used - much admired by Warren and me. As one factor, Graham had this concept of value to a private owner - what the whole enterprise would sell for if it were available. And that was calculable in many cases.

Then, if you could take the stock price and multiply it by the number of shares and get something that was one third or less of sellout value, he would say that you've got a lot of edge going for you. Even with an elderly alcoholic running a stodgy business, this significant excess of real value per share working for you means that all kinds of good things can happen to you. You had a huge margin of safety - as he put it - by having this big excess value going for you.

The aftermath of the 1930s was a bargain hunter's dream.

Munger: But he was, by and large, operating when the world was in shell-shock from the 1930s - which was the worst contraction in the English-speaking world in about 600 years. Wheat in Liverpool, I believe, got down to something like a 600-year low, adjusted for inflation. People were so shell-shocked for a long time thereafter that Ben Graham could run his Geiger counter over this detritus from the collapse of the 1930s and find things selling below their working capital per share and so on.

Today, stated assets evaporate at the first sign of trouble.

Munger: And in those days, working capital actually belonged to the shareholders, If the employees were no longer useful, you just sacked them all, took the working capital and stuck it in the owners' pockets. That was the way capitalism then worked.

Nowadays, of course, the accounting is not realistic - because the minute the business starts contracting, significant assets are not there. Under social norms and the new legal rules of the civilization, so much is owed to the employees, that the minute the enterprise goes into reverse, some of the assets on the balance sheet aren't there anymore.

Strange things can happen in the technology area.

Munger: Now, that might not be true if you run a little auto dealership yourself. You may be able to run it in a way that there's no health plan and this and that so that if the business gets lousy, you can take your working capital and go home. But IBM can't, or at least didn't. Just look at what disappeared from its balance sheet when it decided that it had to change size both because the world had changed technologically and because its market position had deteriorated.

And in terms of blowing it, IBM is some example. Those were brilliant, disciplined people. But there was enough turmoil in technological change that IBM got bounced off the wave after "surfing" successfully for 60 years. And that was some collapse - an object lesson in the difficulties of technology and one of the reasons why Buffett and Munger don't like technology very much. We don't think we're any good at it, and strange things can happen.

One way to keep finding "bargains" is to redefine the term.

Munger: At any rate, the trouble with what I call the classic Ben Graham concept is that gradually the world wised up and those real obvious bargains disappeared. You could run your Geiger counter over the rubble and it wouldn't click.

But such is the nature of people who have a hammer - to whom, as I mentioned, every problem looks like a nail - that the Ben Graham followers responded by changing the calibration on their Geiger counters. In effect, they started defining a bargain in a different way. And they kept changing the definition so that they could keep doing what they'd always done. And it still worked pretty well. So the Ben Graham intellectual system was a very good one.

Having an unstable business partner has its rewards.

Munger: Of course, the best part of it all was his concept of "Mr. Market". Instead of thinking the market was efficient, he treated it as a manic-depressive who comes by every day. And some days he says, "I'll sell you some of my interest for way less than you think it's worth." And other days, "Mr. Market" comes by and says, "I'll buy your interest at a price that's way higher than you think it's worth." And you get the option of deciding whether you want to buy more, sell part of what you already have or do nothing at all.

To Graham, it was a blessing to be in business with a manic-depressive who gave you this series of options all the time. That was a very significant mental construct. And it's been very useful to Buffett, for instance, over his whole adult lifetime.

GRAHAM WASN'T TRYING TO PLAY OUR GAME

- I.E., PAYING UP FOR BETTER BUSINESSES.

Ben Graham wasn't trying to do what we did.

Munger: However, if we'd stayed with classic Graham the way Ben Graham did it, we would never have had the record we have. And that's because Graham wasn't trying to do what we did.

For example, Graham didn't want to ever talk to management. And his reason was that, like the best sort of professor aiming his teaching at a mass audience, he was trying to invent a system that anybody could use. And he didn't feel that the man in the street could run around and talk to managements and learn things. He also had a concept that the management would often couch the information very shrewdly to mislead. Therefore, it was very difficult. And that is still true, of course - human nature being what it is.

Our leap - paying up for quality....

Munger: And so having started out as Grahamites - which, by the way, worked fine - we gradually got what I would call better insights. And we realized that some company that was selling at 2 or 3 times book value could still be a hell of a bargain because of momentums implicit in its position, sometimes combined with an unusual managerial skill plainly present in some individual or other, or some system or other.

And once we'd gotten over the hurdle of recognizing that a thing could be a bargain based on quantitative measures that would have horrified Graham, we started thinking about better businesses.

Bulk of Berkshire's billions brought by better businesses.

Munger: And, by the way, the bulk of the billions in Berkshire Hathaway have come from the better businesses. Much of the first $200 or $300 million came from scrambling around with our Geiger counter. But the great bulk of the money has come from the great businesses.

And even some of the early money was made by being temporarily present in great businesses, Buffett Partnership, for example, owned American Express and Disney when they got pounded down.

FROM THE VIEWPOINT OF A RATIONAL CLIENT,
INVESTMENT MANAGEMENT TODAY IS BONKERS.

A tremendous advantage at Berkshire - no clients.

Munger: [Most investment managers are] in a game where the clients expect them to know a lot about a lot of things. We didn't have any clients who could fire us at Berkshire Hathaway. So we didn't have to be governed by any such construct. And we came to this notion of finding a

mispriced bet and loading up when we were very confident that we were right. So we're way less diversified. And I think our system is miles better.

However, in all fairness, I don't think [a lot of money managers] could successfully sell their services if they used our system. But if you're investing for 40 years in some pension fund, what difference does it make if the path from start to finish is a little more bumpy or a little different than everybody else's so long as it's all going to work out well in the end? So what if there's a little extra volatility.

Investment management today is really hobbling itself....

Munger: In investment management today, everybody wants not only to win, but to have the path never diverge very much from a standard path except on the upside. Well, that is a very artificial, crazy construct. That's the equivalent in investment management to the custom of binding the feet of the Chinese women. It's the equivalent of what Nietzsche meant when he criticized the man who had a lame leg and was proud of it.

That is really hobbling yourself. Now, investment managers would say. "We have to be that way. That's how we're measured". And they may be right in terms of the way the business is now constructed. But from the viewpoint of a rational consumer, the whole system's "bonkers" and draws a lot of talented people into socially useless activity.

IF YOU DON'T LOAD UP ON GREAT OPPORTUNITIES,
THEN YOU'RE MAKING A BIG MISTAKE.

It's much better to attempt something attainable.

Munger: And the Berkshire system is not "bonkers". It's so damned elementary that even bright people are going to have limited, really valuable insights in a very competitive world when they're fighting against other very bright, hardworking people.

And it makes sense to load up on the very few good insights you have instead of pretending to know everything about everything at all times. You're much more likely to do well if you start out to do something, feasible instead of something that isn't feasible. Isn't that perfectly obvious?

How many of you have 56 brilliant insights in which you have equal confidence? Raise your hands, please. How many of you have two or three insights that you have some confidence in? I rest my case.

I'd say that Berkshire Hathaway's system is adapting to the nature of the investment problem as it really is.

The trick is getting into better businesses.

Munger: We've really made the money out of high quality businesses. In some cases, we bought the whole business. And in some cases, we just bought a big block of stock. But when you analyze what happened, the big money's been made in the high quality businesses. And most of the other people who've made a lot of money have done so in high quality businesses.

Over the long term, it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6% on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6% return - even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with one hell of a result.

Finding 'em small is a very beguiling idea....

Munger: So the trick is getting into better businesses. And that involves all of these advantages of scale that you could consider momentum effects.

How do you get into these great companies? One method is what I'd call the method of finding them small - get 'em when they're little. For example, buy Wal-Mart when Sam Walton first goes public and so forth. And a lot of people try to do just that. And it's a very beguiling idea. If I were a young man, I might actually go into it.

We have to buy 'em big. And it gets harder all the time.

Munger: But it doesn't work for Berkshire Hathaway anymore because we've got too much money. We can't find anything that fits our size parameter that way. Besides, we're set in our ways. But I regard finding them small as a perfectly intelligent approach for somebody to try with discipline. It's just not something that I've done.

Finding 'em big obviously is very hard because of the competition. So far, Berkshire's managed to do it. But can we continue to do it? What's the next Coca-Cola investment for us? Well, the answer to that is I don't know. I think it gets harder for us all the time....

Not loading up on great opportunities is a big mistake.

Munger: And ideally - and we've done a lot of this - you get into a great business which also has a great manager because management matters. For example, it's made a hell of a difference to General Electric that Jack Welch came in instead of the guy who took over Westinghouse - one hell of a difference. So management matters, too.

And some of it is predictable. I do not think it takes a genius to understand that Jack Welch was a more insightful person and a better manager than his peers in other companies. Nor do I think it took tremendous genius to understand that Disney had basic momentums in place which are very powerful and that Eisner and Wells were very unusual managers.

So you do get an occasional opportunity to get into a wonderful business that's being run by a wonderful manager. And, of course, that's hog heaven day. If you don't load up when you get those opportunities, it's a big mistake.

It's usually better to bet on the business than the manager....

Munger: Occasionally, you'll find a human being who's so talented that he can do things that ordinary skilled mortals can't. I would argue that Simon Marks - who was second generation in Marks & Spencer of England - was such a man. Patterson was such a man at National Cash Register. And Sam Walton was such a man,

These people do come along - and in many cases, they're not all that hard to identity. If they've got a reasonable hand - with the fanaticism and intelligence and so on that these people generally bring to the party - then management can matter much.

However, averaged out, betting on the quality of a business is better than betting on the quality of management. In other words, if you have to choose one, bet on the business momentum, not the brilliance of the manager.

But, very rarely, you find a manager who's so good that you're wise to follow him into what looks like a mediocre business.

MAKE A FEW GREAT INVESTMENTS
AND SIT ON YOUR ASSETS....

There are huge mathematical advantages to doing nothing.

Munger: Another very simple effect I very seldom see discussed either by investment managers or anybody else is the effect of taxes. If you're going to buy something which compounds for 30 years at 15% per annum and you pay one 35% tax at the very end, the way that works out is that after taxes, you keep 13.3% per annum,

In contrast, if you bought the same investment, but had to pay taxes every year of 35% out of the 15% that you earned, then your return would be 15% minus 35% of 15% - or only 9.75% per year compounded. So the difference there is over 3.5%. And what 3.5% does to the numbers over long holding periods like 30 years is truly eye-opening. If you sit on your ass for long, long stretches in great companies, you can get a huge edge from nothing but the way income taxes work.

Even with a 10% per annum investment, paying a 35% tax at the end gives you 8.3% after taxes as an annual compounded result after 30 years. In contrast, if you pay the 35% each year instead of at the end, your annual result goes down to 6.5%. So you add nearly 2% of after-tax return per annum if you only achieve an average return by historical standards from common stock investments in companies with low dividend payout ratios.

Tax-related motivations have led to many big boners.

Munger: But in terms of business mistakes that I've seen over a long lifetime, I would say that trying to minimize taxes too much is one of the great standard causes of really dumb mistakes. I see terrible mistakes from people being overly motivated by tax considerations.

Warren and I personally don't drill oil wells. We pay our taxes. And we've done pretty well, so far. Anytime somebody offers you a tax shelter from here on in life, my advice would be don't buy it.

In fact, any time anybody offers you anything with a big commission and a 200-page prospectus. don't buy it. Occasionally, you'll be wrong if you adopt "Munger's Rule". However, over a lifetime, you'll be a long way ahead - and you will miss a lot of unhappy experiences that might otherwise reduce your love for your fellow man.

Make a few great investments and sit on your assets....

Munger: There are huge advantages for an individual to get into a position where you make a few great investments and just sit on your ass: You're paying less to brokers. You're listening to less nonsense. And if it works, the governmental tax system gives you an extra 1, 2 or 3 percentage points per annum compounded.

And you think that most of you are going to get that much advantage by hiring investment counselors and paying them 1% to run around, incurring a lot of taxes on your behalf? Lots of luck.

Great companies' stock prices often reflect their quality.

Munger: Are there any dangers in this philosophy? Yes. Everything in life has dangers. Since it's so obvious that investing in great companies works, it gets horribly overdone from time to time. In the Nifty-Fifty days, everybody could tell which companies were the great ones. So they got up to 50, 60 and 70 times earnings. And just as IBM fell off the wave, other companies did, too. Thus, a large investment disaster resulted from too high prices. And you've got to be aware of that danger....

So there are risks. Nothing is automatic and easy. But if you can find some fairly-priced great company and buy it and sit, that tends to work out very, very well indeed - especially for an individual.

AND THERE'S THE ULTIMATE NO-BRAINER
- LIKE FINDING MONEY IN THE STREET.

The ultimate no-brainer....

Munger: Within the growth stock model, there's a sub-position: There are actually businesses. that you will find a few times in a lifetime, where any manager could raise the return enormously just by raising prices - and yet they haven't done it. So they have huge untapped pricing power that they're not using. That is the ultimate no-brainer.

That existed in Disney. It's such a unique experience to take your grandchild to Disneyland. You're not doing it that often. And there are lots of people in the country. And Disney found that it could raise those prices a lot and the attendance stayed right up.

So a lot of the great record of Eisner and Wells was utter brilliance but the rest came from just raising prices at Disneyland and Disneyworld and through video cassette sales of classic animated movies.

Coca-Cola had it all. It was perfect....

Munger: At Berkshire Hathaway, Warren and I raised the prices of See's Candy a little faster than others might have. And, of course, we invested in Coca-Cola - which had some untapped pricing power. And it also had brilliant management. So a Goizueta and Keough could do much more than raise prices. It was perfect.

You will occasionally find money in the street.

Munger: You will get a few opportunities to profit from finding underpricing. There are actually people out there who don't price everything as high as the market will easily stand. And once you figure that out, it's like finding money in the street - if you have the courage of your convictions.

MODELS FROM BERKSHIRE HATHAWAY INVESTMENTS:
COKE, GILLETTE, GEICO & THE WASHINGTON POST

Model #1: Betting on newspapers in two newspaper towns.

Munger: If you look at Berkshire's investments where a lot of the money's been made and you look for the models, you can see that we twice bought into two-newspaper towns which have since become one-newspaper towns. So we made a bet to some extent....

The Washington Post was a rare opportunity indeed.

Munger: In one of those - The Washington Post - we bought it at about 20% of the value to a private owner. So we bought it on a Ben Graham-style basis - at one-fifth of obvious value - and, in addition, we faced a situation where you had both the top hand in a game that was clearly going to end up with one winner and a management with a lot of integrity and intelligence. That one was a real dream. They're very high class people - the Katharine Graham family. That's why it was a dream - an absolute, damn dream.

Of course, that came about back in '73-'74. And that was almost like 1932. That was probably a once-in-40- years-type denouement in the markets. That investment's up about 50 times over our cost. If I were you, I wouldn't count on getting any investment in your lifetime quite as good as The Washington Post was in '73 and '74.

But it doesn't have to be that good to take care of you.

Model #2: A low-priced item + a global marketing advantage.

Munger: Let me mention another model. Of course, Gillette and Coke make fairly low-priced items and have a tremendous marketing advantage all over the world. And in Gillette's case, they keep surfing along new technology which is fairly simple by the standards of microchips. But it's hard for competitors to do.

So they've been able to stay constantly near the edge of improvements in shaving. There are whole countries where Gillette has more than 90% of the shaving market.

Model #3: The cancer surgery formula - a la GEICO.

Munger: GEICO is a very interesting model. It's another one of the 100 or so models you ought to have in your head. I've had many friends in the sick-business-fix- game over a long lifetime. And they practically all use the following formula - I call it the cancer surgery formula:

They look at this mess. And they figure out if there's anything sound left that can live on its own if they cut away everything else. And if they find anything sound, they just cut away everything else. Of course, if that doesn't work, they liquidate the business. But it frequently does work.

And GEICO had a perfectly magnificent business - submerged in a mess, but still working. Misled by success, GEICO had done some foolish things. They got to thinking that, because they were making a lot of money, they knew everything. And they suffered huge losses.

All they had to do was to cut out all the folly and go back to the perfectly wonderful business that was lying there. And when you think about it, that's a very simple model. And it's repeated over and over again.

And, in GEICO's case, think about all the money we passively made.... It was a wonderful business combined with a bunch of foolishness that could easily he cut out. And people were coming in who were temperamentally and intellectually designed so they were going to cut it out. That is a model you want to look for.

And you may find one or two or three in a long lifetime that are very good. And you may find 20 or 30 that are good enough to be quite useful.

THE INVESTMENT MANAGEMENT BUSINESS:
DON'T PRACTICE PSYCHOLOGICAL DENIAL

Investment managers as a whole don't add any value....

Munger: Finally, I'd like to once again talk about investment management. That is a funny business - because on a net basis, the whole investment management business together gives no value added to all buyers combined. That's the way it has to work.

Of course, that isn't true of plumbing and it isn't true of medicine. If you're going to make your careers in the investment management business, you face a very peculiar situation. And most investment managers handle it with psychological denial -just like a chiropractor. That is the standard method of handling the limitations of the investment management process. But if you want to live the best sort of life, I would urge each of you not to use the psychological denial mode.

However, it's not impossible to add value.

Munger: I think a select few - a small percentage of the investment managers - can deliver value added. But I don't think brilliance alone is enough to do it. I think that you have to have a little of this discipline of calling your shots and loading up - if you want to maximize your chances of becoming one who provides above average real returns for clients over the long pull.

But I'm just talking about investment managers engaged in common stock picking. I am agnostic elsewhere. I think there may well be people who are so shrewd about currencies and this, that and the other thing that they can achieve good long-term records operating on a pretty big scale in that way. But that doesn't happen to be my milieu. I'm talking about stock picking in American stocks.

I think it's hard to provide a lot of value added to the investment management client, but it's not impossible.

--OID

This is an *adaptation* from Munger's July 20, 1996 informal talk, *Practical Thought about Practical Thought?*

Charlie Munger, "The title of my talk is "Practical Thought About Practical Thought? with a question mark at the end."

Better methods of thought

In a long career, I have assimilated various ultra-simple general notions that I find helpful in solving problems. **Five of these helpful notions I will now describe. After that, I will present to you a problem of extreme scale.** Indeed, the problem will involve turning start-up capital of $2 million into $2 trillion, a sum large enough to represent a practical achievement. Then I will try to solve the problem, assisted by my helpful general notions. Following that, I will suggest that there are important educational implications in my demonstration. I will so finish because my objective is educational, my game today being a search for better methods of thought.

Decide big "no-brainer" questions first.

The first helpful notion is that it is usually best to simplify problems by deciding big "no-brainer" questions first.

Numerical fluency

The second helpful notion mimics Galileo's conclusion that scientific reality is often revealed only by math as if math was the language of God. Galileo's attitude also works well in messy, practical life. Without numerical fluency, in the part of life most of us inhabit, you are like a one-legged man in an ass-kicking contest.

Invert, always invert

The third helpful notion is that it is not enough to think problems through forward. You must also think in reverse, much like the rustic who wanted to know where he was going to die so that he'd never go there. Indeed, many problems can't be solved forward. And that is why the great algebraist Carl Jacobi so often said, **"Invert, always invert."** And why the Pythagoreans[1] thought in reverse to prove that the square root of two was an irrational number.

Think in a multidisciplinary manner

The fourth helpful notion is that the best and most practical wisdom is elementary academic wisdom. But there is one extremely important qualification: You must think in a multidisciplinary manner. You must routinely use all the easy-to-learn concepts from the freshman course in every basic subject. Where elementary ideas will serve, your problem solving must not be limited, as academia and many business bureaucracies are limited, by extreme balkanization

[1] Pythagoras (582-496 BC), an Ionian (Greek) mathematician and philosopher known as "the father of numbers," is often credited with the discovery of irrational numbers. More likely though, the credit belongs to one or more of his followers, the Pythagoreans, who produced a proof of the irrationality of the square root of two. But Pythagoras, believing that numbers were absolute, rejected irrational numbers and is said to have sentenced their leading proponent to death by drowning for his heresy. Generally, an irrational number is any real number that cannot be written as a fraction "a/b," with "a" and "b" integers, and "b" not zero. For a number to be irrational, its expansion in any given base (decimal, binary, etc.) never ends and never enters a periodic pattern.

into disciplines and sub-disciplines, with strong taboos against any venture outside assigned territory. Instead, you must do your multi-disciplinary thinking in accord with Ben Franklin's prescription in Poor Richard: "If you want it done, go. If not, send."

Multi-disciplinary thinking

If, in your thinking, you rely entirely on others, often through purchase of professional advice, whenever outside a small territory of your own, you will suffer much calamity.[2] And it is not just difficulties in complex coordination that will do you in. You will also suffer from the reality evoked by the Savian character who said, "In the last analysis, **every profession is a conspiracy against the laity."** Indeed, a Shavian character, for once, understated the horrors of something Shaw didn't like. It is not usually the conscious malfeasance of your narrow professional adviser that does you in. Instead, your troubles come from his *subconscious bias*. His cognition will often be impaired, for your purposed, by financial incentives different from yours. And he will also suffer from the psychological defect caused by the proverb: "To a man with a hammer, every problem looks like a nail."

Lollapalooza effects

The fifth helpful notion is that really big effects, lollapalooza effects, will often come only from large combinations of factors. For instance, tuberculosis was tamed, at least for a long time, only by routine, combined use in each case of three different drugs. Another lollapalooza effects, like the flight of an airplane, follow a similar pattern.

My practical problem

It is now time to present my practical problem. And here is the problem: It is 1884 in Atlanta, Ga. You are brought, along with twenty others like you, before a rich and eccentric Atlanta citizen named Glotz. Both you and Glotz share two characteristics: First, you routinely use in problem solving the **five helpful notions**, and, second, you know all the elementary ideas in all the basic college courses, as taught in 1996. However, all discoverers, and all examples demonstrating these elementary ideas come from dates before 1884. Neither you nor GlotZ know anything about anything that has happened after 1884.

Glotz offers to invest two million 1884 dollars, yet take only half the equity, for a Glotz Charitable Foundation, in a new corporation organized to go into the non-alcoholic beverage business and remain in that business only, forever. Glotz wants to use a name that has somehow charmed him: Coca-Cola.

The other half of the new corporation's equity will go to the man who most plausibly demonstrates that his business plan will cause Glotz's foundation to be worth a trillion dollars 150 years later, in the money of that later time, 2034, despite paying out a large part of its earnings each year as a dividend. This will make the whole new corporation worth $2 trillion, even after paying out many billions of dollars in dividends.

[2] Danger of consultants: http://www.amazon.com/Dangerous-Company-Consulting-Powerhouses-Businesses/dp/0756756006/ref=sr_1_1?s=books&ie=UTF8&qid=1324347970&sr=1-1

You have fifteen minutes to make your pitch. What do you say to Glotz?

Here is my solution, my pitch to Glotz, using only the helpful notions and what every bright college sophomore should know.

Focus first on big, "no-brainer" decisions first

Well, Glotz, the big "no-brainer" decisions that, to simplify our problem, should be made first are as follows: First, we are never going to create something worth $2 trillion by selling some generic beverage. Therefore, we must make your name, "Coca-Cola," into a strong, legally protected trademark. Second, we can get to $2 trillion only by starting in Atlanta, then succeeding in the rest of the United States, then rapidly succeeding with our new beverage all over the world. This will require developing a product having universal appeal because it harnesses powerful elemental forces. And the right place to find such powerful elemental forces is in the subject matter of elementary academic courses.

Numerical fluency

We will next use numerical fluency to ascertain what our target implies. We can guess reasonably that by 2034 there will be about eight billion beverage consumers in the world. On average, each of these consumers will be much more prosperous in real terms than the average consumer of 1884. Each consumer is composed mostly of water and must ingest about sixty-four ounces of water per day. This is eight, eight-ounce servings. Thus, if our new beverage, and other imitative beverages in our market, can flavor and otherwise improve only twenty-five percent of ingested water worldwide, and we can occupy half of the new world market, we can sell 2.92 trillion eight ounce servings in 2034. And if we can then **net four cents per serving**, we will earn $117 billion. This will be enough, if our business is still growing at a good rate, to make it easily worth $2 trillion.

Universal appeal

A big question, of course, is whether four cents per serving is a reasonable profit target for 2034. And the answer is yes if we can create a beverage with strong universal appeal. One hundred and fifty years is a long time. The dollar, like the Roman drachma, will almost surely suffer monetary depreciation. Concurrently, real purchasing power of the average beverage consumer in the world will go way up. His proclivity to inexpensively improve his experience while ingesting water will go up considerably faster. Meanwhile, as technology improves, the cost of our simple product, in units of constant purchasing power, will go down. All four factors will work together in favor of our four-cents-per-serving profit target. Worldwide beverage-purchasing power in dollars will probably multiply by a factor of at least forty over 150 years. Thinking in reverse, this makes our profits-per-serving large, under 1884 conditions, a mere one fortieth of four cents or one tenth of a cent per serving. This is an easy-to-exceed target as we start out if our new product has universal appeal.

That decided, we must next solve **the problem of invention to create universal appeal**. There are two intertwined challenges of large scale: First, over 150 years, we must cause a new-beverage market to assimilate about one-fourth of the world's water ingestion. Second, we must

so operate that half the new market is ours while all our competitors combined are left to share the remaining half. These results are lollapalooza results. Accordingly, we must attack our problem by causing every favorable factor we can think of to work for us. Plainly, only a powerful combination of many factors is likely to cause the lollapalooza consequences we desire. Fortunately, the solution to these intertwined problems turns out to be fairly easy if one has stayed awake in all the freshman courses.

Operant conditioning

Let us start by exploring the consequences of our simplifying "no-brainer" decision that we must rely on a *strong trademark*. This conclusion automatically leads to an understanding of the essence of our business in proper elementary academic terms. We can see from the introductory course in psychology that, in essence, we are going into the business of creating and **maintaining conditioned reflexes**. The "Coca-Cola" trade name and trade dress will act as the stimuli, I and the purchase and ingestation of our beverage will be the desired responses.

"I want a can of Coke within arm's reach of every American serviceman—something to remind him of home." –Dwight D. Eisenhower, Supreme Allied Commander, WWII

And how does one create and maintain conditioned reflexes? Well, the psychology text gives two answers:

1. By operant conditioning and
2. By classical conditioning, often called Pavlovian[3] conditioning to honor the great Russian scientist.

And, since we want a lollapalooza result, we must use both conditioning techniques—and all we can invent to enhance effects from each technique.

The operant conditioning part of our problem is easy to solve. We need only

1. Maximize rewards of our beverage's ingestion and
2. Minimize possibilities that desire reflexes, once created by us, will be extinguished through operant conditioning by proprietors of competing products.

For operant conditioning rewards, there are only a few categories we will find practical:

1. Food value in calories or other inputs;
2. Flavor, texture, and aroma acting as stimuli to consumption under neural preprogramming of man through Darwinian natural selection;
3. Stimulus, as by sugar or caffeine;
4. Cooling effect when man is too hot or warming effect when man is too cool;
5. Wanting a lollapalooza result, we will naturally include rewards in *all* the categories.

[3] Pavlov's most famous experiment showed that dogs tend to salivate before food is actually delivered to their mouths. This result led him to a long series of experiments in which he manipulated the stimuli occurring before the presentation of food. He thereby established the basic laws for the establishment and extinction of what he called "conditional reflexes." Later mistranslated from the original Russian as "conditioned reflexes." He was awarded the Nobel Prize in 1904 for his work on digestive secretions.

To start out, it is easy to decide to design our beverage for consumption cold. There is much less opportunity, without ingesting beverage, to counteract excessive heat, compared with excessive cold. Moreover, with excessive heat, much liquid must be consumed, and the reverse is not true. It is also easy to decide to include both sugar and caffeine. After all, tea, coffee, and lemonade are already widely consumed. And, it is also clear that we must be fanatic about determining, through trial and error, flavor and other characteristics that will maximize human pleasure while taking in the sugared water and caffeine we will provide. And, to counteract possibilities that desired operant-conditioned reflexes, once created by us, will be extinguished by operant-conditioning-employing competing products, there is also an obvious answer: We will make it a permanent obsession in our company that our beverage, as fast as practicable, will at **all times be available everywhere throughout the world**. After all, a competing product, if is never tried, can't account as a reward creating a conflicting habit. Every spouse knows that.

We must next consider the Pavlovian conditioning we must also use. In Pavlovian conditioning, powerful effects come from *mere association*[4]. The neural system of Pavlov's dog causes it to salivate at the bell it can't eat. And the brain of man yearns for the type of beverage held by the pretty woman he can't have. And so, Glotz, we must use every sort of decent, honorable Pavlovian conditioning we can think of. For as long as we are in business, our beverage and its promotion must be associated in consumer minds with all other things consumers like or admire.

Such extensive Pavlovian conditioning will cost a lot of money, particularly for advertising. We still spend big money as far ahead as we can imagine. But the money will be effectively spent. As we expand fast in our new-beverage market, **our competitors will face gross disadvantages of scale in buying advertising to create the Pavlovian condition they need.** And this outcome, along with other volume-creates – power effects, would help us gain and hold at least fifty percent of the new market everywhere. Indeed, provided buyers are scattered, our higher volumes will give us very extreme cost advantages in distribution.

Moreover, Pavlovian effects from mere association will help us choose the flavor, texture, and color of our new beverage. Considering Pavlovian effects, we will have wisely chosen the exotic and expensive-sounding name "Coca-Cola," instead of a pedestrian name like "Glotz's Sugared, Caffeinated Water." For similar Pavlovian reasons, it will be wise to have our beverage look pretty much like wine instead of sugared water. And so, we will artificially color our beverage if it comes out clear. And we will carbonate our water, making our product seem like champagne, or some other expensive beverage, while also making its flavor better and imitation harder to arrange for competing products. And, because we are going to attach so many expensive psychological effects to our flavor, that flavor should be different from any other standard flavor so that we maximize difficulties for competitors and give no accidental same-flavor benefit to any existing product.

[4] http://www.coca-colaconversations.com/my_weblog/2011/01/things-go-better-with-coke.html

Social proof[5]

What else, from the psychology textbook, can help our new business? Well, there is that powerful "monkey-see, monkey-do" aspect of human nature that psychologists often call **"social proof."** Social proof, imitative consumption triggered by mere sight of consumption, will not only help induce trial of our beverage. It will also bolster perceived rewards from consumption. We still always take this powerful social-proof factor into account. We design advertising and sales promotion and as we forego present profit to enhance present and future consumption. More than with most other products, increased selling power will come from each increase in sales.

Lollapalooza effects

We can now see, Glotz, that by combining

1. Much Pavlovian conditioning
2. Powerful social-proof effects,
3. And a wonderful-tasting, energy-giving, stimulating and desirably cold beverage that causes much operant conditioning, we are going to get sales that speed up for a long time by reason of the huge mix of factors we have chosen.

Therefore, we are going to start something like an **autocatalytic reaction in chemistry**, precisely the sort of multi-factor triggered lollapalooza effect we need.

The logistics and the distribution strategy of our business will be simple. There are only two practical ways to sell our beverage:

1. As syrup to fountains and restaurants
2. And as a complete carbonated-water product in containers.

Wanting lollapalooza results, we will naturally do it both ways. And, wanting huge Pavlovian and social-proof effects, we will always spend on advertising and sale promotion, per serving, over forty percent of the fountain price for syrup needed to make the serving.

A few syrup making plants can serve the world. However, to avoid needless shipping .of mere space and water, we will need many bottling plants scattered over the world. We will maximize profits if (like early General Electric with light bulbs) we always set the first-sale price, either

1. For fountain syrup or
2. For any container of our complete product.

[5] Social Proof: Orange Juice Futures Trading in the movie, *Trading Places* with Eddie Murphy: http://www.youtube.com/watch?v=TSZKDkLgzhk (See example at 3:40).

The best way to arrange this desirable profit-maximizing control is to make any independent bottler we need a *subcontractor*, not a vendee of syrup, and certainly not a vendee of syrup under a perpetual franchise specifying a syrup process frozen forever at its starting level.

Being unable to get a patent or copyright on our super important flavor, we will work obsessively to keep our **formula secret**. We will make a big hoopla over our secrecy, which will enhance Pavlovian effects. Eventually, food-chemical engineering will advance so that out flavor can be copied with near exactitude. **But, by that time, we will be so far ahead, with such strong trademark and complete, "always available" worldwide distribution, that good flavor copying won't bar us from our objective.** Moreover, the advances in food chemistry that help competitors will almost surely be accompanied by technological advances that will help us, including refrigeration, better transportation, and , for dieters, ability to insert a sugar taste without inserting sugar's calories. Also, there will be related beverage opportunities we will seize.

What must we avoid?

This brings us to a final reality check for our business plan. We will, once more, **think in reverse** like Jacobi. What must we avoid because we don't want it? Four answers seem clear.

1. First, we must avoid the protective, cloying, stop-consumption effects of *aftertaste* that are a standard part of physiology, developed through Darwinian evolution to enhance the replication of man's genes by forcing a generally helpful moderation on the gene carrier. To serve our ends, on hot days, a consumer must be able to drink container after container of our product with almost no impediment from aftertaste. We will find a wonderful no-aftertaste flavor by trial and error and will thereby solve this problem.
2. Second, we must avoid ever losing even half of our powerful trademarked name. It will cost us mightily, for instance, if our sloppiness should ever allow sale of any other kind of "cola," for instance, a "peppy cola." If there is ever a "peppy cola," we will be the proprietor of the brand.
3. Third, with so much success coming, we must avoid bad effects from **envy**, which is given a prominent place in the *Ten Commandments*[6] because envy is so much a part of human nature. The best way to avoid envy, recognized by Aristotle, is to plainly deserve the success we get. We will be fanatic about product quality, quality of product presentation, and reasonableness of prices, considering the harmless pleasure we still provide.
4. Fourth, after our trademarked flavor dominates our new market, we must avoid making any huge and sudden change in our flavor. Even if a new flavor performs better in blind taste tests, changing to that new flavor would be a foolish thing to do. This follows because, under such conditions, **our old flavor will be so entrenched in consumer**

[6] The Ten Commandments were a list of religious and moral imperatives that featured prominently in Judaism and Christianity. According to the Bible, the commandments represent the solemn utterances of God directly revealed to Moses and then by Moses to the people of Israel. The commandments are: 1. I am the Lord thy God, thou shall have no other Gods before me. 2. Thou shalt not take the name of the Lord thy God in vain. 3. Remember the Sabbath and keep it holy, 4. Honor they father and they mother. 5. Thou shalt not kill. 6. Thou shalt not commit adultery. 7. Thou shalt not steal. 8. Thou shalt not bear false witness against thy neighbor. 9. Thou shalt not covet they neighbor's wife. 10. Thou shalt not covet they neighbor's house or anything else that is they neighbor's.

preference by psychological effects that a big flavor change would do us little good[7]. And it would do immense harm by triggering in consumers the standard deprival super-reaction syndrome that makes "take-away" so hard to get in any type of negotiation and helps make most gamblers so irrational. Moreover, such a large flavor change would allow a competitor, by copying our old flavor, to take advantage of both.

- The hostile consumer super-reaction to deprival and
- The huge love our original flavor created by our previous work.

Well, that is my solution to my own problem of turning $2 million into $2 trillion even after paying out billions of dollars in dividends. I think it would have won with Glotz in 1884 and should convince you more than you expected at the outset. After all, the correct strategies are clear after being related to elementary academic ideas brought into platy by the helpful notions.

Coca-Cola's History

How consistent is my solution with the history of the real Coca-Cola Company? Well, as late as 1896, twelve years after the fictional Glotz was to start vigorously with two million 1884 dollars, the real Coca-Cola Company had a net worth under $150,000 and earnings of about zero. And thereafter, the real Coca-Cola company did lose half its trademark and did grant perpetual bottling franchises at fixed syrup prices. And some of the bottlers were not very effective and couldn't easily be change. And the real Coca-Cola Company, with this system, did lose much pricing control that would have improved results, and had it been retained. Yet, even so, the real Coca-Cola Company followed so much of the plan given to Glotz that is now worth about $125 billion and will have to increase its value at only eight percent per year until 12034 to reach a value of $2 trillion. And it can hit an annual physical volume target of 2.92 trillion servings if servings grow until 2034 at only six percent per year, a result consistent with much past experience and leaving plenty of plain-water ingestation for Coca-Cola to replace after 2034. So, I would guess that the fictional Glotz, starting earlier and strong and avoiding the worst errors, would have easily hit his $2 trillion target. And he would have done it well before 2034.

A gap in understanding

This brings me, at last, to the main purpose of my talk, Large educational implications exist, if my answer to Glotz's problem is roughly right and you make one more assumption I believe true—that most Ph.D. educators, even psychology professors and business school deans, would not have given the same simple answer I did. And, if I am right in these two ways, this would indicate that **our civilization now keeps in place a great many educators who can't satisfactorily explain Coca-Cola**, even in retrospect, and even after watching it closely all their lives. This is not a satisfactory state of affairs.

Moreover-and this result is even more extreme—the brilliant and effective executives who surrounded by business school and law school graduates, have run the Coca-Cola Company

[7] Habits once formed are difficult to break

with glorious success in recent years also did not understand elementary psychology well enough to predict and avoid the “New Coke” fiasco, which dangerously threatened their company. That people so talented, surrounded by professional advisers from the best universities, would thus demonstrate a huge gap in their education is also not a satisfactory state of affairs.

Such extreme ignorance, in both the high reached of academia and the high reaches of business is a lollapalooza effect of a negative sort, demonstrating grave defects in academia. Because the bad effect is a lollapalooza, we should expect to find intertwined, multiple academic causes. I suspect at least two such causes.

First, academic psychology, while it is admirable and useful as a list of ingenious and important experi8ments, lacks intra-disciplinary synthesis. In particular, not enough attention is given to lollapalooza effects coming from combinations of psychological tendencies. This creates a situation reminding one of a rustic teacher who tries to simplify school work by rounding pi to an even three. And it violates Einstein’s injunction that “everything should be made as simple as possible—but no more simple. “ In general, psychology is laid out and misunderstood as electromagnetism would now be misunderstood if physics and produced many brilliant experimenters like Michael Faraday and no grand synthesizer like James Clerk Maxwell.

Lack of synthesis

And, second, there is a truly horrible lack of synthesis blending psychology and other academic subjects. But only an interdisciplinary approach will correctly deal with reality—in academia as with the Coca-Cola Company.

In short, academic psychology departments are immensely more important and useful than other academic departments think. And, at the same time, the psychology departments are immensely worse than most of their inhabitants think. It is, of course, normal for self-appraisal to be more positive than external appraisal. Indeed, a problem of this sort may have given you your speaker today. But the size of this psychology-department gap is preposterously large. In fact, the gap is so enormous that one very eminent university (Chicago) simply abolished tis psychology department, perhaps with an undisclosed hope of later creating a better version.

In such a state of affairs, many years ago and with much that was plainly wrong already present, the “New Coke” fiasco occurred[8]. Therein, Coke’s executives came to the brink of destroying the most valuable trademark in the world. The academically correct reaction to this immense and well-publicized fiasco would have been the sort of reaction Boeing would display if three of its new airplanes crashed in a single week. After all, product integrity is involved in each case, and the plain educational failure was immense.

But almost no such responsible, Boeing-like reaction has come from academia. Instead, academia, by and large, continues in its balkanized way to tolerate psychology professors who mis-teach psychology, non-psychology professors who fail to consider psychological effects

[8] http://www.thecoca-colacompany.com/heritage/cokelore_newcoke.html

obviously crucial in their subject matter, and professional schools that carefully preserve psychological ignorance coming in with each entering class and are proud of their inadequacies.

Even though this regrettable blindness and lassitude is now the normal academic result, are there exceptions providing hope that disgraceful shortcomings of the education establishment will eventually be corrected? Here, my answer is a very optimistic year.

For instance, consider the recent behavior of the economics department of the University of Chicago. Over the last decade, this department has enjoyed a near monopoly of the Nobel prizes in economics, largely by getting good predictions out of “free markets models postulating main’s rationality. And what is the reaction of this department after winning so steadily with its rational-man approach?

Well, it has just invited into a precious slot amid its company of greats a wise and witty Cornell economist, Richard Thaler (http://faculty.chicagobooth.edu/richard.thaler/research/). And it has done this because Thaler pokes fun at much that is holy at the University of Chicago. Indeed, Thaler believes, with me, that **people are often massively irrational in ways predicted by psychology that must be taken into account in microeconomics.**

In so behaving, the University of Chicago is imitating Darwin[9], who spent much of his long life **thinking in reverse** as he tried to disprove his own hardest-won and best-loved ideas. And so long as there are parts of academia that keep alive its best values by thinking in reverse like Darwin, we can confidently expect that silly educational practices will eventually be replaced by better ones, exactly as Carl Jacobi might have predicted.

Darwin’s habitual objectivity

This will happen because the Darwinian approach, with its **habitual objectivity** taken on as a sort of hair shirt, is a mighty approach, indeed. No less a figure than Einstein said that one of the four causes of his achievement was self-criticism, ranking right up there alongside curiosity, concentration, and perseverance.

And, to further appreciate the power of self-criticism, consider where lies the grave of that very “ungifted” undergraduate, Charles Darwin. It is in Westminster Abbey, right next to the headstone of Isaac Newton, perhaps the most gifted student who ever lives, honored on the headstone in eight Latin words constituting the most eloquent praise in all graveyard print: *“Hic depositum est, quod mortale fuit Isaaci Newtoni”—Here lies that which was mortal of Isaac Newton.”*

A civilization that so places a dead Darwin will eventually develop and integrate psychology in a proper and practical fashion that greatly increases skills of all sorts. But all of us who have dollops of power and see the light should help the process along. There is a lot at stake. **If, in many high places, a universal product as successful as Coca-Cola is not properly**

[9] http://www.aboutdarwin.com/index.html

understood and explained, it can't bode well for our competency in dealing with much else that is important.

Of course, those of you with fifty percent of net worth in Coca-Cola stock, occurring because you tried to so invest ten percent after thinking like I did in making my pitch to Glotz, can ignore my message about psychology as too elementary for useful transmission to you. But I am not so sure that this reaction is wise for the rest of you. The situation reminds me of the old-time Warner & Swasey ad that was a favorite of mine: "The company that needs a new machine tool, and hasn't bought it, is already paying for it."

Source: *Poor Charlie's Almanack, The Wit and Wisdom of Charles T. Munger, Expanded Second Edition*

Investment Practices of Leading Charitable Foundations

Speech of Charles T. Munger, Vice Chair, Berkshire Hathaway, at Miramar Sheraton Hotel, Santa Monica, CA, on October 14, 1998, to a meeting of the Foundation Financial Officers Group sponsored by The Conrad Hilton Foundation, The Amateur Athletic Foundation, The J. Paul Getty Trust, and Rio Hondo Memorial Foundation. The speech is reproduced here (http://www.tiff.org/pub/library/Other_Resources/Munger_Speech.html) with Mr. Munger's permission.

I am speaking here today because my friend, John Argue, asked me. And John well knew that I, who, unlike many other speakers on your agenda, have nothing to sell any of you, would be irreverent about much current investment practice in large institutions, including charitable foundations. Therefore any hostility my talk will cause should be directed at John Argue who comes from the legal profession and may even enjoy it.

It was long the norm at large charitable foundations to invest mostly in unleveraged, marketable, domestic securities, mostly equities. The equities were selected by one or a very few investment counselling organizations. But in recent years there has been a drift toward more complexity. Some foundations, following the lead of institutions like Yale, have tried to become much better versions of Bernie Cornfeld's "fund of funds." This is an amazing development. Few would have predicted that, long after Cornfeld's fall into disgrace, leading universities would be leading foundations into Cornfeld's system.

Now, in some foundations, there are not few but many investment counselors, chosen by an additional layer of consultants who are hired to decide which investment counselors are best, help in allocating funds to various categories, make sure that foreign securities are not neglected in favor of domestic securities, check validity of claimed investment records, insure that claimed investment styles are scrupulously followed, and help augment an already large diversification in a way that conforms to the latest notions of corporate finance professors about volatility and "beta."

But even with this amazingly active, would-be-polymathic new layer of consultant-choosing consultants, the individual investment counselors, in picking common stocks, still rely to a considerable extent on a third layer of consultants. The third layer consists of the security analysts employed by investment banks. These security analysts receive enormous salaries, sometimes set in seven figures after bidding wars. The hiring investment banks recoup these salaries from two sources: (1) commissions and trading spreads born by security buyers (some of which are rebated as "soft dollars" to money managers), plus (2) investment banking charges paid by corporations which appreciate the enthusiastic way their securities are being recommended by the security analysts.

There is one thing sure about all this complexity including its touches of behavior lacking the full punctilio of honor. Even when nothing but unleveraged stock-picking is involved, the total cost of all the investment management, plus the frictional costs of fairly often getting in and out of many large investment positions, can easily reach 3% of foundation net worth per annum if foundations, urged on by consultants, add new activity, year after year. This full cost doesn't show up in conventional accounting. But that is because accounting has limitations and not because the full cost isn't present.

Next, we come to time for a little arithmetic: it is one thing each year to pay the croupiers 3% of starting wealth when the average foundation is enjoying a real return, say, of 17% before the croupiers' take. But it is not written in the stars that foundations will always gain 17% gross, a common result in recent years. And if the average annual gross real return from indexed investment in equities goes back, say, to 5% over some long future period, and the croupiers' take turns out to remain the waste it has always been, even for the average intelligent player, then the average intelligent foundation will be in a prolonged, uncomfortable, shrinking mode. After all, 5% minus 3% minus 5% in donations leaves an annual shrinkage of 3%.

All the equity investors, in total, will surely bear a performance disadvantage per annum equal to the total croupiers' costs they have jointly elected to bear. This is an unescapable fact of life. And it is also unescapable that exactly half of the investors will get a result below the median result after the croupiers' take, which median result may well be somewhere between unexciting and lousy.

Human nature being what it is, most people assume away worries like those I raise. After all, five centuries before Christ Demosthenes noted that: "What a man wishes, he will believe." And in self appraisals of prospects and talents it is the norm, as Demosthenes predicted, for people to be ridiculously over-optimistic. For instance, a careful survey in Sweden showed that 90% of automobile drivers considered themselves above average. And people who are successfully selling something, as investment counselors do, make Swedish drivers sound like depressives. Virtually every investment expert's public assessment is that he is above average, no matter what is the evidence to the contrary.

But, you may think, my foundation, at least, will be above average. It is well endowed, hires the best, and considers all investment issues at length and with objective professionalism. And to this I respond that an excess of what seems like professionalism will often hurt you horribly — precisely because the careful procedures themselves often lead to overconfidence in their outcome.

General Motors recently made just such a mistake, and it was a lollapalooza. Using fancy consumer surveys, its excess of professionalism, it concluded not to put a fourth door in a truck designed to serve also as the equivalent of a comfortable five-passenger car. Its competitors, more basic, had actually seen five people enter and exit cars. Moreover they had noticed that people were used to four doors in a comfortable five-passenger car and that biological creatures ordinarily prefer effort minimization in routine activies and don't like removals of long-enjoyed benefits. There are only two words that come instantly to mind in reviewing General Motors horrible decision, which has blown many hundreds of millions of dollars. And one of those words is: "oops."

Similarly, the hedge fund known as "Long Term Capital Management" recently collapsed, through overconfidence in its highly leveraged methods, despite I.Qs. of its principals that must have averaged 160. Smart, hard-working people aren't exempted from professional disasters from overconfidence. Often, they just go around in the more difficult voyages they choose, relying on their self-appraisals that they have superior talents and methods.

It is, of course, irritating that extra care in thinking is not all good but also introduces extra error. But most good things have undesired "side effects," and thinking is no exception. The best defense is that of the best physicists, who systematically criticize themselves to an extreme degree, using a mindset described by Nobel Laureate Richard Feynman as follows: "The first principle is that you must not fool yourself and you're the easiest person to fool."

But suppose that an abnormally realistic foundation, thinking like Feynman, fears a poor future investment outcome because it is unwilling to assume that its unleveraged equities will outperform equity indexes, minus all investment costs, merely because the foundation has adopted the approach of becoming a "fund of funds," with much investment turnover and layers of consultants that consider themselves above average. What are this fearful foundation's options as it seeks improved prospects?

There are at least three modern choices:

1. The foundation can both dispense with its consultants and reduce its investment turnover as it changes to indexed investment in equities.

2. The foundation can follow the example of Berkshire Hathaway, and thus get total annual croupier costs below 1/10 of 1% of principal per annum, by investing with virtually total passivity in a very few much-admired domestic corporations. And there is no reason why some outside advice can't be used in this process. All the fee payor has to do is suitably control the high talent in investment counseling organizations so that the servant becomes the useful tool of its master, instead of serving itself under the perverse incentives of a sort of Mad Hatter's tea party.

3. The foundation can supplement unleveraged investment in marketable equities with investment in limited partnerships that do some combination of the following: unleveraged investment in high-tech corporations in their infancy; leveraged investments in corporate buy-outs, leveraged relative value trades in equities, and leveraged convergence trades and other exotic trades in all kinds of securities and derivatives.

For the obvious reasons given by purveyors of indexed equities, I think choice (1), indexing, is a wiser choice for the average foundation than what it is now doing in unleveraged equity investment. And particularly so as its present total croupier costs exceed 1% of principal per annum. Indexing can't work well forever if almost everybody turns to it. But it will work all right for a long time.

Choice (3), investment in fancy limited partnerships, is largely beyond the scope of this talk. I will only say that the Munger Foundation does not so invest, and briefly mention two considerations bearing on "LBO" funds.

The first consideration bearing on LBO funds is that buying 100% of corporations with much financial leverage and two layers of promotional carry (one for the management and one for the general partners in the LBO fund) is no sure thing to outperform equity indexes in the future if equity indexes perform poorly in the future. In substance, a LBO fund is a better way of buying equivalents of marketable equities on margin, and the debt could prove disastrous if future

marketable equity performance is bad. And particularly so if the bad performance comes from generally bad business conditions.

The second consideration is increasing competition for LBO candidates. For instance, if the LBO candidates are good service corporations, General Electric can now buy more than $10 billion worth per year in GE's credit corporation, with 100% debt financing at an interest rate only slightly higher than the U.S. Government is paying. This sort of thing is not ordinary competition, but supercompetition. And there are now very many LBO funds, both large and small, mostly awash in money and with general partners highly incentivized to buy something. In addition there is increased buying competition from corporations other than GE, using some combination of debt and equity.

In short, in the LBO field, there is a buried covariance with marketable equities — toward disaster in generally bad business conditions — and competition is now extreme.

Given time limitation, I can say no more about limited partnerships, one of which I once ran. This leaves for extensive discussion only foundation choice (2), more imitation of the investment practices of Berkshire Hathaway in maintaining marketable equity portfolios with virtually zero turnover and with only a very few stocks chosen. This brings us to the question of how much investment diversification is desirable at foundations.

I have more than skepticism regarding the orthodox view that huge diversification is a must for those wise enough so that indexation is not the logical mode for equity investment. I think the orthodox view is grossly mistaken.

In the United States, a person or institution with almost all wealth invested, long term, in just three fine domestic corporations is securely rich. And why should such an owner care if at any time most other investors are faring somewhat better or worse. And particularly so when he rationally believes, like Berkshire, that his long-term results will be superior by reason of his lower costs, required emphasis on long-term effects, and concentration in his most preferred choices.

I go even further. I think it can be a rational choice, in some situations, for a family or a foundation to remain 90% concentrated in one equity. Indeed, I hope the Mungers follow roughly this course. And I note that the Woodruff foundations have, so far, proven extremely wise to retain an approximately 90% concentration in the founder's Coca-Cola stock. It would be interesting to calculate just how all American foundations would have fared if they had never sold a share of founder's stock. Very many, I think, would now be much better off. But, you may say, the diversifiers simply took out insurance against a catastrophe that didn't occur. And I reply: there are worse things than some foundation's losing relative clout in the world, and rich institutions, like rich individuals, should do a lot of self insurance if they want to maximize long-term results.

Furthermore, all the good in the world is not done by foundation donations. Much more good is done through the ordinary business operations of the corporations in which the foundations invest. And some corporations do much more good than others in a way that gives investors therein better than average long-term prospects do. And I don't consider it foolish, stupid, evil, or illegal for a foundation to greatly concentrate investment in what it admires or even loves. Indeed, Ben

Franklin required just such an investment practice for the charitable endowment created by his will.

One other aspect of Berkshire's equity investment practice deserves comparative mention. So far, there has been almost no direct foreign investment at Berkshire and much foreign investment at foundations.

Regarding this divergent history, I wish to say that I agree with Peter Drucker that the culture and legal systems of the United States are especially favorable to shareholder interests, compared to other interests and compared to most other countries. Indeed, there are many other countries where any good going to public shareholders has a very low priority and almost every other constituency stands higher in line. This factor, I think is underweighed at many investment institutions, probably because it does not easily lead to quantitative thinking using modern financial technique. But some important factor doesn't lose share of force just because some "expert" can better measure other types of force. Generally, I tend to prefer over direct foreign investment Berkshire's practice of participating in foreign economies through the likes of Coca-Cola and Gillette.

To conclude, I will make one controversial prediction and one controversial argument.

The controversial prediction is that, if some of you make your investment style more like Berkshire Hathaway's, in a long-term retrospect you will be unlikely to have cause for regret, even if you can't get Warren Buffett to work for nothing. Instead, Berkshire will have cause for regret as it faces more intelligent investment competition. But Berkshire won't actually regret any disadvantage from your enlightenment. We only want what success we can get despite encouraging others to share our general views about reality.

My controversial argument is an additional consideration weighing against the complex, high-cost investment modalities becoming ever more popular at foundations. Even if, contrary to my suspicions, such modalities should turn out to work pretty well, most of the money-making activity would contain profoundly antisocial effects. This would be so because the activity would exacerbate the current, harmful trend in which ever more of the nation's ethical young brainpower is attracted into lucrative money-management and its attendant modern frictions, as distinguished from work providing much more value to others. Money management does not create the right examples. Early Charlie Munger is a horrible career model for the young, because not enough was delivered to civilization in return for what was wrested from capitalism. And other similar career models are even worse.

Rather than encourage such models, a more constructive choice at foundations is long-term investment concentration in a few domestic corporations that are wisely admired.

Why not thus imitate Ben Franklin? After all, old Ben was very effective in doing public good. And he was a pretty good investor, too. Better his model, I think, than Bernie Cornfeld's. The choice is plainly yours to make.

Master's Class

Berkshire Hathaway's vice chairman shreds the conventional wisdom on foundation investing

By Charles Munger, 1999

It was long the norm at large charitable foundations to invest mostly in unleveraged, marketable, domestic securities, mostly equities. The equities were selected by one or a very few investment counseling organizations. But in recent years there has been a drift toward more complexity. Some foundations, following the lead of institutions like Yale, have tried to become much better versions of Bernie Cornfeld's "fund of funds." This is an amazing development. Few would have predicted that, decades after his fall into disgrace, leading universities would be leading foundations into Cornfeld's system.

Now, in some foundations, there are not few but many investment counselors, chosen by an additional layer of consultants who are hired to decide which investment counselors are best, help in allocating funds to various categories, make sure that foreign securities are not neglected in favor of domestic securities, check validity of claimed investment records, ensure that claimed investment styles are scrupulously followed, and help augment an already large diversification in a way that conforms to the latest notions of corporate finance professors about measures of volatility.

But even with this amazingly active, would-be-polymathic new layer of consultant-choosing consultants, in picking common stocks the individual investment counselors still rely to a considerable extent on a third layer of consultants. The third layer consists of the security analysts employed by investment banks. These security analysts receive enormous salaries, sometimes set in seven figures after bidding wars. The hiring investment banks recoup these salaries from two sources: First, from commissions and trading spreads borne by securities buyers; and second, from investment banking charges paid by corporations which appreciate the enthusiastic way their securities are being recommended by the security analysts.

There is one sure thing about all this complexity, including its touches of behavior lacking the full punctilio of honor. Even when nothing but unleveraged stock-picking is involved, the total cost of all the investment management, plus the frictional costs of fairly often getting in and out of many large investment positions, can easily reach 3 percent of foundation net worth per annum if foundations, urged by consultants, add new activity year after year. This full cost doesn't show up in conventional accounting. But that is because accounting has limitations and not because the full cost isn't present.

Where Every Investment Advisor Is Above-Average

Now is time for a little arithmetic: It is one thing each year to pay the croupiers 3 percent of starting wealth when the average foundation is enjoying a real return, say, of 17 percent before the croupiers' take. But it is not written in the stars that foundations will

always gain 17 percent gross, a common result in recent years. And if the average annual gross real return from indexed investment in equities goes back, say, to 5 percent over some long future period, and the croupiers' take turns out to remain the waste it has always been, even for the average intelligent players, then the average intelligent foundation will be in a prolonged, uncomfortable, shrinking mode. After all, 5 percent minus 3 percent minus 5 percent in donations leaves an annual shrink of 3 percent.

All the equity investors, in total, will surely bear a performance disadvantage per annum equal to the total croupiers' costs they have jointly elected to bear. This is an inescapable fact of life. And it is also inescapable that exactly half of the investors will get a result below the median result after the croupiers' take, which median result may well be somewhere between unexciting and lousy.

Human nature being what it is, most people assume away worries like those I raise. After all, in the 5th century B. C. Demosthenes noted that: "What a man wishes, he will believe." And in self-appraisals of prospects and talents it is the norm, as Demosthenes predicted, for people to be ridiculously over-optimistic. For instance, a careful survey in Sweden showed that 90 percent of automobile drivers considered themselves above average. And people who are successfully selling something, as investment counselors do, make Swedish drivers sound like depressives. Virtually every investment expert's public assessment is that he is above average, no matter what is the evidence to the contrary.

"But," some will say, "my foundation, at least, will be above average. It is well-endowed, hires the best, and considers all investment issues at length and with objective professionalism." And to this I respond that an excess of what seems like professionalism will often hurt you horribly—precisely because the careful procedures themselves often lead to overconfidence in their outcome.

Not long ago, General Motors made just such a mistake, and it was a lollapalooza. Using fancy consumer surveys, its excess of professionalism, it decided not to put a fourth door in a truck designed to serve also as the equivalent of a comfortable five-passenger car. Its competitors, more basic, had actually seen five people enter and exit cars. Moreover they had noticed that people were used to four doors in a comfortable five-passenger car and that biological creatures ordinarily prefer effort minimization in routine activities and don't like removals of long-enjoyed benefits. There are only two words that come instantly to mind in reviewing General Motors horrible decision, which has blown many hundreds of millions of dollars. And one of those words is: "Oops."

Similarly, the hedge fund known as "Long Term Capital Management" collapsed last fall through overconfidence in its highly leveraged methods, despite I.Q.'s of its principals that must have averaged 160. Smart people aren't exempt from professional disasters from overconfidence. Often, they just run aground in the more difficult voyages they choose, relying on their self-appraisals that they have superior talents and methods.

Investment Secrets of Richard Feynman

It is, of course, irritating that extra care in thinking is not all good but actually introduces extra error. But most good things have undesired "side effects," and thinking is no exception. The best defense is that of the best physicists, who systematically criticize themselves to an extreme degree, using a mindset described by Nobel laureate Richard Feynman as follows: "The first principle is that you must not fool yourself and you're the easiest person to fool."

But suppose that an abnormally realistic foundation, thinking like Feynman, fears a poor future investment outcome because it is unwilling to assume that its unleveraged equities, after deducting all investment costs, will outperform equity indexes, merely because the foundation has adopted the approach of becoming a "fund of funds" with much investment turnover and layers of consultants that consider themselves above average. What are this fearful foundation's options as it seeks improved prospects? There are at least three modern choices:

• The foundation can both dispense with its consultants and reduce its investment turnover as it changes to indexed investment in equities.

• The foundation can follow the example of Berkshire Hathaway, and thus get total annual croupier costs below 0.1 percent of principal per annum, by investing with virtually total passivity in a very few much-admired domestic corporations. And there is no reason why some outside advice can't be used in this process. All the fee payer has to do is suitably control the high talent in investment counseling organizations so that the servant becomes the useful tool of its master, instead of serving itself under the perverse incentives of a sort of mad hatter's tea party.

• The foundation can supplement unleveraged investment in marketable equities with investment in limited partnerships that do some combination of the following: Unleveraged investment in high-tech corporations in their infancy, leveraged investments in corporate buy-outs, leveraged relative value trades in equities, and leveraged convergence trades and other exotic trades in all kinds of securities and derivatives.

For the obvious reasons given by purveyors of indexed equities, I think choice #1, indexing, is a wiser choice for the average foundation than what it is now doing in unleveraged equity investment. And particularly so as its present total croupier costs exceed 1 percent of principal per annum. Indexing can't work well forever if almost everybody turns to it. But it will work alright for a long time.

Contending with Supercompetitors

Choice #3, investment in fancy limited partnerships, is largely beyond the scope of this article. I will only note that the Munger Foundation does not so invest and briefly mention two considerations bearing on leveraged buyout (LBO) funds.

The first consideration bearing on LBO funds is that buying 100 percent of corporations with much financial leverage and two layers of promotional carry (one for the management and one for the general partners in the LBO fund) is no sure thing to outperform equity indexes in the future if equity indexes perform poorly in the future. In substance, an LBO fund is a better way of buying equivalents of marketable equities on margin, and the debt could prove disastrous if future marketable equity performance is bad. And particularly so if the bad performance comes from generally bad business conditions.

The second consideration is increasing competition for LBO candidates. For instance, if the LBO candidates are good service corporations, General Electric can now buy more than $10 billion worth per year in GE's credit corporation, with 100 percent debt financing at an interest rate only slightly higher than the U.S. government is paying. This is not ordinary competition, but supercompetition. And there are now very many LBO funds, both large and small, mostly awash in money and with general partners highly incentivized to buy something. In addition, there is increased buying competition from corporations other than GE, using come combination of debt and equity.

In short, in the LBO field there is a buried "covariance" with marketable equities, toward disaster in generally bad business conditions, and competition is now extremely intense.

This brings us to foundation choice #2—more imitation of the investment practices of Berkshire Hathaway in maintaining marketable equity portfolios with virtually zero turnover and with only a very few stocks chosen. And that in turn raises the question of how much investment diversification is desirable for foundations.

I am more than skeptical of the orthodox view that huge diversification is a must for those wise enough that indexation is not the logical mode for equity investment. I think the orthodox view is grossly mistaken.

In the United States, a person or institution with almost all wealth invested long-term in just three fine domestic corporations is securely rich. And why should such an owner care if at any time most other investors are faring somewhat better or worse? And particularly so when he rationally believes, like Berkshire, that his long-term results will be superior by reason of his lower costs, required emphasis on long-term effects, and concentration in his most-preferred choices.

I would go even further. I think it can be a rational choice, in some situations, for a family or a foundation to remain 90 percent concentrated in one equity. Indeed, I hope the Mungers follow roughly this course. And I note that the Robert Woodruff Foundations have, so far, proven extremely wise to retain an approximately 90 percent concentration in the founder's Coca-Cola stock. It would be interesting to calculate just how all American foundations would have fared if they had never sold a share of the founder's stock. Very many, I think, would now be much better off. But, some would say, the diversifiers simply took out insurance against a catastrophe that didn't occur. And I reply: There are worse things than a foundation's losing relative clout in the world,

and rich institutions, like rich individuals, should do a lot of self-insurance if they want to maximize long-term results.

Furthermore, all the good in the world is not done by foundation donations. Much more good is done through the ordinary business operations of the corporations in which the foundations invest. And some corporations do much more good than others in a way that gives investors therein better than average long-term prospects. And I don't consider it foolish, stupid, evil, or illegal for a foundation to greatly concentrate investment in what it admires or even loves. Indeed, Ben Franklin required just such an investment practice for the charitable endowment created by his will.

Investing Abroad—at Home

So far, there has been almost no direct foreign investment at Berkshire and much foreign investment at foundations.

Regarding this divergent history, I have to agree with Peter Drucker that the culture and legal systems of the United States are especially favorable to shareholder interests, compared to other interests and compared to most other countries. Indeed, there are many other countries where any good going to public shareholders has a very low priority and almost every other constituency stands higher in line. This factor, I think is underweighed at many investment institutions, probably because it does not easily lead to quantitative thinking using modern financial techniques. But some important factor doesn't lose its "share of force" just because some "expert" can better measure other types of force. Generally, I tend to prefer over direct foreign investment Berkshire's practice of participating in foreign economies through the likes of Coca-Cola and Gillette.

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The one controversial prediction is that, if some foundations make their investment style more like Berkshire Hathaway's, in a long-term retrospect they will be unlikely to have cause for regret, even if they can't get Warren Buffett to work for nothing. Instead, Berkshire will have cause for regret as it faces more intelligent investment competition. But Berkshire won't actually regret any disadvantage from their enlightenment.

My controversial argument is an additional consideration weighing against the complex, high-cost investment modalities becoming ever more popular at foundations. Even if, contrary to my suspicions, such modalities should turn out to work pretty well, most of the money-making activity would contain profoundly antisocial effects. This, because the activity would exacerbate the current harmful trend in which ever more of the nation's ethical young brainpower is attracted into lucrative money-management and its attendant modern frictions, as distinguished from work providing much more value to others. Money management simply does not create the right examples. Early Charlie Munger is a horrible career model for the young because not enough was delivered to civilization in return for what was wrested from capitalism. And other similar career models are even worse.

Rather than encourage such models, a more constructive choice at foundations is long-term investment concentration in a few domestic corporations that are wisely admired.

Why not thus imitate Ben Franklin? After all, old Ben was very effective in doing public good. And he was a pretty good investor, too. Better his model, I think, than Bernie Cornfeld's.

Charles T. Munger is vice chairman of Berkshire Hathaway Inc., and president of the Los Angeles-based Alfred C. Munger Foundation. This article is adapted from Mr. Munger's recent speech at a meeting of the Foundation Financial Officers Group.

A Perverse Use of Antitrust Law.

by Charles T. Munger. September 2000.

As best I can judge from the Microsoft antitrust case, the Justice Department believes that any seller of an ever-evolving, many-featured product--a product that is constantly being improved by adding new features to every new model--will automatically violate antitrust law if: (1) it regularly sells its product at one all-features-included price; (2) it has a dominant market share and (3) the seller plays "catch-up" by adding an obviously essential feature that has the same function as a product first marketed by someone else.

If appellate courts are foolish enough to go along with the trial court ruling in the Microsoft case, virtually every dominant high-tech business in the United States will be forced to retreat from what is standard competitive practice for firms all over the world when they are threatened by better technology first marketed elsewhere.

No other country so ties the hands of its strongest businesses. We can see why by taking a look at America's own history. Consider the Ford Motor Co. When it was the dominant U.S. automaker in 1912, a small firm-a predecessor of General Motors-invented a self-starter that the driver could use from inside the car instead of getting out to crank the engine. What Ford did in response was to add a self-starter of its own to its cars (its "one-price" package)-thus bolstering its dominant business and limiting the inroads of its small competitor. Do we really want that kind of conduct to be illegal?

Or consider Boeing. Assume Boeing is selling 90 percent of U.S. airliners, always on a one-price basis despite the continuous addition of better features to the planes. Do we really want Boeing to stop trying to make its competitive position stronger-as it also helps travelers and improves safety by adding these desirable features-just because some of these features were first marketed by other manufacturers?

The questions posed by the Microsoft case are: (1) what constitutes the impermissible and illegal practice of "tying" a separate new product to a dominant old product, and (2) what constitutes the permissible and legal practice of improving an existing one-price product that is dominant in the market.

The solution, to avoid ridiculous results and arguments, is easy. We need a

simple, improvement-friendly rule that a new feature is always a permissible improvement if there is any plausible argument whatever that product users are in some way better off.

It is the nature of the modern era that the highest standards of living usually come where we find many super-successful corporations that keep their high market shares mostly through fanatical devotion to improving one-price products.

In recent years, one microeconomic trend has been crucial in helping the United States play catch-up against foreign manufacturers that had developed better and cheaper products: our manufacturers learned to buy ever-larger, one-price packages of features from fewer and more-trusted suppliers. This essential modern trend is now threatened by the Justice Department.

Microsoft may have some peculiarities of culture that many people don't like, but it could well be that good software is now best developed within such a culture. Microsoft may have been unwise to deny that it paid attention to the competitive effects of its actions. But this is the course legal advisers often recommend in a case such as this one, where individuals' motives at Microsoft were mixed and differed from person to person. A proper antitrust policy should not materially penalize defendants who make the government prove its case. The incumbent rulers of the Justice Department are not fit to hold in trust the guidance of antitrust policy if they allow such considerations of litigation style to govern the development of antitrust law, a serious business with serious consequences outside the case in question.
While I have never owned a share of Microsoft, I have long watched the improvement of its software from two vantage points. First, I am an officer and part owner of Berkshire Hathaway Inc., publisher of the World Book Encyclopedia, a product I much admire because I know how hard it was to create and because I grew up with it and found that it helped me throughout a long life.

But despite our careful stewardship of World Book, the value of its encyclopedia business was grossly and permanently impaired when Microsoft started including a whole encyclopedia, at virtually no addition in price, in it software package. Moreover, I believe Microsoft did this hoping to improve its strong business and knowing it would hurt ours.

Even so, and despite the huge damage to World Book, I believe Microsoft was entitled to improve its software as it did, and that our society gains

greatly--despite some damage to some companies--when its strong businesses are able to improve their products enough to stay strong. Second, I am chairman and part owner of Daily Journal Corp., publisher of many small newspapers much read by lawyers and judges. Long ago, this corporation was in thrall to IBM for its highly computerized operation. Then it was in thrall to DEC for an even more computerized operation. Now it uses, on a virtually 100 percent basis, amazingly cheap Microsoft software in personal computers, in a still more highly computerized operation including Internet access that makes use of Microsoft's browsers.

Given this history of vanished once-dominant suppliers to Daily Journal Corp., Microsoft's business position looks precarious to me. Yet, for a while at least, the pervasiveness of Microsoft products in our business and elsewhere helps us--as well as the courts that make use of our publications--in a huge way.

But Microsoft software would be a lousy product for us and the courts if the company were not always improving it by adding features such as Explorer, the Internet browser Microsoft was forced to add to Windows on a catch-up basis if it didn't want to start moving backward instead of forward.

The Justice Department could hardly have come up with a more harmful set of demands than those it now makes. If it wins, our country will end up hobbling its best-performing high-tech businesses. And this will be done in an attempt to get public benefits that no one can rationally predict.

Andy Grove of Intel, a company that not long ago was forced out of a silicon chip business in which it was once dominant, has been widely quoted as describing his business as one in which "only the paranoid survive." If this is so, as seems likely, then Microsoft should get a medal, not an antitrust prosecution, for being so fearful of being left behind and so passionate about improving its products.

Charles T. Munger is vice chairman of Berkshire Hathaway Inc. and chairman and part owner of Daily Journal Corp.

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11/10/00 TALK OF CHARLES T. MUNGER TO BREAKFAST MEETING OF THE PHILANTHROPY ROUND TABLE

I am here today to talk about so-called "wealth effects" from rising prices for U.S. Common stocks.

I should concede, at the outset, that "wealth effects" are part of the academic discipline of economics and that I have never taken a single course in economics, nor tried to make a single dollar, ever, from foreseeing macroeconomic changes.

Nonetheless, I have concluded that most PhD economists under appraise the power of the common-stock-based "wealth effect", under current extreme conditions.

Everyone now agrees on two things. First, spending proclivity is influenced in an upward direction when stock prices go up and in a downward direction when stock prices go down. And, second, the proclivity to spend is terribly important in macroeconomics. However, the professionals disagree about size and timing of "wealth effects", and how they interact with other effects, including the obvious complication that increased spending tends to drive up stock prices while stock prices are concurrently driving up spending. Also, of course, rising stock prices increase corporate earnings, even when spending is static, for instance, by reducing pension cost accruals after which stock prices tend to rise more. Thus "wealth effects" involve mathematical puzzles that are not nearly so well worked out as physics theories and never can be.

The "wealth effect" from rising U.S. stock prices is particularly interesting right now for two reasons. First, there has never been an advance so extreme in the price of widespread stock holdings and, with stock prices going up so much faster than GNP, the related "wealth effect" must now be bigger than was common before. And second, what has happened in Japan over roughly the last ten years has shaken up academic economics, as it obviously should, creating strong worries about recession from "wealth effects" in reverse.

In Japan, with much financial corruption, there was an extreme rise in stock and real estate prices for a very long time, accompanied by extreme real economic growth, compared to the U.S. Then asset values crashed and the Japanese economy stalled out at a very suboptimal level. After this Japan, a modem economy that had learned all the would-be-corrective Keynesian and monetary tricks, pushed these tricks hard and long. Japan, for many years, not only ran an immense government deficit but also reduced interest rates to a place within hailing distance of zero, and kept them there. Nonetheless, the Japanese economy year after year, stays stalled, as Japanese proclivity to spend stubbornly resists all the tricks of the economists. And Japanese stock prices stay down. This Japanese experience is a disturbing example for everyone, and, if something like it happened here, would leave shrunken charitable foundations feeling clobbered by fate. Let us hope, as is probably the case, that the sad situation in Japan is caused in some large part by social psychological effects and corruption peculiar to Japan. In such case our country may be at least half as safe as is widely assumed.

Well, grant that spending proclivity, as influenced by stock prices, is now an important subject, and that the long Japanese recession is disturbing. How big are the economic influences of U.S.

stock prices? A median conclusion of the economics professionals, based mostly on data collected by the Federal Reserve System, would probably be that the "wealth effect" on spending from stock prices is not all that big. After all, even now, real household net worth, excluding pensions, is probably up by less than 100% over the last ten years and remains a pretty modest figure per household while market value of common stock is probably not yet one third of aggregate household net worth, excluding pensions. Moreover, such household wealth in common stocks is almost incredibly concentrated, and the super-rich don't consume in proportion to their wealth. Leaving out pensions, the top 1% of households probably hold about 50% of common stock value and the bottom 80% probably hold about 4%.

Based, on such data, plus unexciting past correlation between stock prices and spending, it is easy for a professional economist to conclude, say, that, even if the average household spends incrementally at a rate of 3% of asset values in stock, consumer spending would have risen less than ½% per year over the last ten years as a consequence of the huge, unprecedented, long lasting, consistent boom is stock prices.

I believe that such economic thinking widely misses underlying reality right now. To me, such thinking looks at the wrong numbers and asks the wrong questions. Let me, the ultimate amateur, boldly try to do a little better, or at least a little differently.

For one thing, I have been told, probably correctly, that Federal Reserve data collection, due to practical obstacles, doesn't properly take into account pension effects, including effects from 401(k) and similar plans. Assume some 63-year-old dentist has $1 million in GE stock in a private pension plan. The stock goes up in value to $2 million, and the dentist, feeling flush, trades in his very old Chevrolet and leases a new Cadillac at the give-away rate now common. To me this is an obvious large "wealth effect" in the dentist's spending. To many economists, using Federal Reserve data, I suspect the occasion looks like profligate dissaving by the dentist. To me the dentist, and many others like him, seem to be spending a lot more because of a very strong pension-related "wealth effect". Accordingly, I believe that present day "wealth effect" from pension plans is far from trivial and much larger than it was in the past.

For another thing, the traditional thinking of economists often does not take into account implications from the idea of "bezzle". Let me repeat: "bezzle", B-E-Z-Z-L-E.

The word "bezzle" is a contraction of the word "embezzle", and it was coined by Harvard Economics Professor John Kenneth Galbraith to stand for the increase in any period of undisclosed embezzlement. Galbraith coined the "bezzle" word because he saw that undisclosed embezzlement, per dollar, had a very powerful stimulating effect on spending. After all, the embezzler spends more because he has more income, and his employer spends as before because he doesn't know any of his assets are gone.

But Galbraith did not push his insight on. He was content to stop with being a stimulating gadfly. So I will now try to push Galbraith's "bezzle" concept on to the next logical level. As Keynes showed, in a naive economy relying on earned income, when the seamstress sells a coat to the shoemaker for $20, the shoemaker has $20 more to spend and the seamstress has $20 less to spend. There is lalapaloose effect on aggregate spending. But when the government prints

another $20 bill and uses it to buy pair of shoes, the shoemaker has another $20 and no one feels poorer. And when the shoemaker next buys a coat, - the process goes on and on, not to an infinite increase, but with what is now called the Keynesian multiplier effect, a sort of lalapaloosa effect on spending. Similarly, an undisclosed embezzlement has stronger stimulative effects per dollar on spending than a same-sized honest exchange of goods. Galbraith, being Scottish, liked the bleakness of life demonstrated by his insight. After all, the Scottish enthusiastically accepted the idea of pre-ordained, unfixable infant damnation. But the rest of us don't like Galbraith's insight. Nevertheless, we have to recognize that Galbraith was roughly right.

No doubt Galbraith saw the Keynesian-multiplier-type economic effects promised by increases in "bezzle". But he stopped there. After all, "bezzle" could not grow very big, because discovery of massive theft was nearly inevitable and sure to have reverse effects in due course. Thus, increase in private "bezzle" could not drive economies up and up, and on and on, at least for a considerable time, like government spending.

Deterred by the apparent smallness of economic effects from his insight, Galbraith did not ask the next logical question: Are there important functional equivalents of "bezzle" that are large and not promptly self-destructive? My answer to this question is yes. I will next describe only one. I will join Galbraith in coining new words, first, "febezzle", to stand for the functional equivalent of "bezzle" and, second, "febezzlement", to describe the process of creating "febezzle", and third "febezzlers" to describe persons engaged in "febezzlement". Then I will identify an important source of "febezzle" right in this room. You people, I think, have created a lot of "febezzle" through your foolish investment management practices in dealing with your large holdings of common stock.

If a foundation, or other investor, wastes 3% of assets per year in unnecessary, nonproductive investment costs in managing a strongly rising stock portfolio, it still feels richer, despite the waste, while the people getting the wasted 3%, "febezzelers" though they are, think they are virtuously earning income. The situation is functioning like undisclosed embezzlement without being self-limited. Indeed, the process can expand for a long while by feeding on itself. And all the while what looks like spending from earned income of the receivers of the wasted 3% is, in substance, spending from a disguised "wealth effect" from rising stock prices.

This room contains many people pretty well stricken by expired years --- in my generation or the one following. We tend to believe in thrift and avoiding waste as good things, a process that has worked well for us. It is paradoxical and disturbing to us that economists have long praised foolish spending as a necessary ingredient of a successful economy. Let us call foolish expenditures "foolexures". And now you holders of old values are hearing one of you own add to the case for "foolexures" the case for "febezzlements" --- the functional equivalent of embezzlements. This may not seem like a nice way to start a new day. Please be assured that I don't like "febezzlements". It is just that I think "febezzlements" are widespread and have powerful economic effects. And I also think that one should recognize reality even when one doesn't like it, indeed especially when one doesn't like it. Also, I think one should cheerfully endure paradox that one can't remove by good thinking. Even in pure mathematics they can't remove all paradox, and the rest of us should also recognize we are going to have to endure a lot of paradox, like it or not.

Let me also take this occasion to state that my previous notion of 3% of assets per annum in waste in much institutional investment management related to stocks is quite likely too low in a great many cases. A friend, after my talk to foundation financial officers, sent me a summary of a study about mutual fund investors. The study concluded that the typical mutual fund investor gained at 7.25% per year in a 15-year period when the average stock fund gained at 12.8% per year (presumably after expenses). Thus the real performance lag for investors was over 5% of assets per year in addition to whatever percentage per year the mutual funds, after expenses, lagged behind stock market averages. If this mutual fund study is roughly right, it raises huge questions about foundation wisdom in changing investment managers all the time as mutual fund investors do. If the extra lag reported in the mutual fund study exists, it is probably caused in considerable measure by folly in constant removal of assets from lagging portfolio managers being forced to liquidate stockholdings, followed by placement of removed assets with new investment managers that have high-pressure, asset-gaining hoses in their mouths and clients whose investment results will not be improved by the super-rapid injection of new funds. I am always having trouble like that caused by this new mutual fund study. I describe something realistically that looks so awful that my description is disregarded as extreme satire instead of reality. Next, new reality tops the horror of my disbelieved description by some large amount. No wonder Munger notions of reality are not widely welcome. This may be my last talk to charitable foundations.

Now toss in with "febezzlement" in investment management about $750 billion in floating, ever-growing, ever-renewing wealth from employee stock options and you get lot more common-stock-related "wealth effect", driving consumption, with some of the "wealth effect" from employee stock options being, in substance, "febezzle" effect, facilitated by the corrupt accounting practice now required by law.

Next consider that each 100-point advance in the S&P adds about $1 trillion in stock market value, and throw in some sort of Keynesian-type multiplier effect related to all "febezzlement". The related macro-economic "wealth effects", I believe, become much larger than is conventionally supposed.

And aggregate "wealth effect" from stock prices can get very large indeed. It is an unfortunate fact that great and foolish excess can come into prices of common stocks in the aggregate. They are valued partly like bonds, based on roughly rational projections of use value in producing future cash. But they are also valued partly like Rembrandt paintings, purchased mostly because their prices have gone up, so far. This situation, combined with big "wealth effects", at first up and later down, can conceivably produce much mischief. Let us try to investigate this by a "thought experiment". One of the big British pension funds once bought a lot of ancient art, planning to sell it ten years later, which it did, at a modest profit. Suppose all pension funds purchased ancient art, and only ancient art, with all their assets. Wouldn't we eventually have a terrible mess on our hands, with great and undesirable macroeconomic consequences? And wouldn't the mess be bad if only half of all pension funds were invested in ancient art? And if half of all stock value became a consequence of mania, isn't the situation much like the case wherein half of pension assets are ancient art?

My foregoing acceptance of the possibility that stock value in aggregate can become irrationally high is contrary to the hard-form “efficient market” theory that many of you once learned as gospel from your mistaken professors of yore. Your mistaken professors were too much influenced by “rational man” models of human behavior from economics and too little by “foolish man” models from psychology and real-world experience. “Crowd folly”, the tendency of humans, under some circumstances, to resemble lemmings, explains much foolish thinking of brilliant men and much foolish behavior --- like investment management practices of many foundations represented here today. It is sad that today each institutional investor apparently fears most of all that its investment practices will be different from practices of the rest of the crowd.

Well, this is enough uncredentialed musing for one breakfast meeting. If I am at all right, our - present prosperity has had a stronger boost from common-stock-price-related “wealth effects”, some of them disgusting, than has been the case in many former booms. If so, what was greater on the upside in the recent boom could also be greater on the downside at some time of future stock price decline. Incidentally, the economists may well conclude, eventually, that, when stock market advances and declines are regarded as long lasting, there is more downside force on optional consumption per dollar of stock market decline than there is upside force per dollar of stock market rise. I suspect that economists would believe this already if they were more willing to take assistance from the best ideas outside their own discipline, or even to look harder at Japan.

Remembering Japan, I also want to raise the possibility that there are, in the very long term, “virtue effects” in economics--- for instance that widespread corrupt accounting will eventually create bad long term consequences as a sort of obverse effect from the virtue-based boost double-entry book-keeping gave to the heyday of Venice. I suggest that when the financial scene starts reminding you of Sodom and Gomorrah, you should fear practical consequences even if you like to participate in what is going on.

Finally, I believe that implications for charitable foundations of my conclusions today, combined with conclusions in my former talk to foundation financial officers, go way beyond implications for investment techniques. If I am right, almost all U.S. foundations are unwise through failure to understand their own investment operations, related to the larger system. If so, this is not good. A rough rule in life is that an organization foolish in one way in dealing with a complex system is all too likely to be foolish in another. So the wisdom of foundation donations may need as much improvement as investment practices of foundations. And here we have two more old rules to guide us. One rule is ethical and the other is prudential.

The ethical rule is from Samuel Johnson who believed that maintenance of easily removable ignorance by a responsible office holder was treacherous malfeasance in meeting moral obligation. The prudential rule is that underlying the old Warner & Swasey advertisement for machine tools: “The man who needs a new machine tool, and hasn’t bought it, is already paying for it”. The Warner & Swasey rule also applies, I believe, to thinking tools. If you don’t have the right thinking tools, you, and the people you seek to help, are already suffering from your easily removable ignorance.

Optimism Has No Place in Accounting

By Charles T. Munger April 4, 2002

The fiasco at Enron had two causes: (1) perverted "financial engineering" that portrayed failure as progress and (2) generally accepted accounting principles that practically invited delusion and fraud.

The faults of those who misled now get much attention and create demands for greater criminal penalties. But the faults of generally accepted accounting principles are more important, because changing accounting rules, and the way they are adopted, has a greater potential for preventing Enron-type disasters.

Fools and knaves, like those at Enron, will always be with us and will be particularly active where big money can be made -- for instance, in reporting ever-higher earnings.

Therefore, accounting rules must make it very difficult for fools and knaves to fake profits and net assets. Every retailer knows that his "shrink rate" from stealing depends on his maintaining a system that makes it hard for anyone to get away with theft. Similarly, sound accounting must make it difficult for

corporations to get away with presenting failure as success.

A rule-making system that instead makes misuse of numbers easy operates like a retailing system without cash registers. Troubles are sure to come in each instance, no matter what the criminal penalties, because neither system insists on the margin of safety demanded by, say, engineering, which seeks to prevent damage from inevitable human foibles. For instance, engineering, reacting to many avoidable deaths in surgery, created anesthesia machines that do not permit operators to reduce oxygen delivery to zero. Wise accounting rules must display similar shrewdness in preventing undesirable accounting.

The way to get maximum safety from accounting rules is to force a pessimistic outlook. In the long term, huge public benefits are to be gained, with almost no public dangers, from pessimistic accounting, while optimistic accounting is a public menace.

Seldom has this been better demonstrated than in the case of Enron, where optimistic accounting of its derivatives trading resulted in a "front-ending" of too much dubious and uncollected revenue into earnings. In the first part of this charade, generally accepted accounting principles allowed "marked to market" valuations, based on defective information about market prices and inadequate allowance for the risks

of clearing trades. Later, hundreds of turgid pages of accounting rules were used to justify determining earnings on a "mark to model" basis, in which "model" prices were calculated by the very traders subject to audit while they were paid bonuses based on reported profits.

The system of generally accepted accounting principles is defective because the desires of accounting firms and the wishes of their clients make it so. Moreover, because significant parts of the system are rotten to the core, the trouble will not be limited to firms that engaged in derivatives trading or hired the accounting firm Arthur Andersen. Huge vested interests love misleading accounting. And the Securities and Exchange Commission, even under a would-be reformer like Arthur Levitt, can't bring about much reform because it is deterred by politicians serving the vested interests.

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To so state the problem suggests a solution: placing the control of accounting much farther away than it now is from the influence of accounting firms, corporations and politicians.

Thus, our model for accounting rule-making should

more independent than the Federal Reserve System. Second, the SEC must be required to enforce the standards established by the new rule-setters.

These rule-makers should be at least as expert, determined and virtuous as Paul Volcker was when he tamed inflation. They should also be less removable than the head of the Fed. After all, folly often is not appraised as such by those who profit from it, and eliminating it will be painful for some.

Some people think that, to correct accounting, we merely need some new committee or some increase in power for the SEC. But these ideas have failed, time after time, because they are equivalent to trying to influence an elephant with a peashooter. We need a stronger remedy.

The writer is vice chairman of Berkshire Hathaway Inc.

"Academic Economics: Strengths and Faults After Considering Interdisciplinary Needs"

Herb Kay Undergraduate Lecture
University of California, Santa Barbara
Economics Department

By Charles T. Munger

October 3, 2003

Transcript by Whitney Tilson, T2 Partners LLC (feedback@T2PartnersLLC.com) who did original light editing and added web links. Later light editing by the speaker.

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Introduction by Rajnish Mehra

Music. Good afternoon. I am Rajnish Mehra, chair of the Economics Department [www.econ.ucsb.edu/~mehra/], and on behalf of the entire department it is my pleasure to welcome you to our annual Herb Kay Undergraduate Lecture, underwritten by the generosity of Herb Kay. Herb was on our faculty in the '60s and has remained a friend and benefactor of the Department. We are very fortunate to have Herb here in the audience today. So please join me in giving him a very warm welcome. (Applause).

Mr. Munger's achievements are very great. They are too numerous for me to detail here. He attended Caltech and Harvard, and in addition to being Vice Chair at Berkshire Hathaway, he's the chair of a major legal newspaper corporation and also Wesco Financial Corporation. He's the President of the Alfred C. Munger Foundation, a philanthropic foundation named after his father. He's on the Forbes 400 list – and what makes that achievement remarkable is that he got there the old fashioned way: He earned it. (Laughter).

He's – after Warren Buffett – the largest shareholder in Berkshire Hathaway. And as you can see he's a fan of Coke, both of the stock and the drink. (Laughter).

It's a personal privilege to introduce Mr. Munger to the UCSB community. I have long been a fan of his Mungerisms. And to quote a particular favorite one that has served me in good stead: Never wrestle with a pig, for if you do, you will both get dirty, but the pig will enjoy it. (Laughter).

Ladies and gentlemen, please join me in welcoming Charles Munger. He will speak to us today on Interdisciplinary Wisdom Involving Economics.

Munger's Opening Remarks:

I've outlined some remarks in a rough way, and after I'm finished talking from that outline, I'll take questions as long as anybody can endure listening, until they drag me away to wherever else I'm supposed to go.

As you might guess, I agreed to do this because the subject of getting the soft sciences so they talked better to each other has been one that has interested me for decades. And, of course, economics is in many respects the queen of the soft sciences. It's expected to be better than the rest. It's my view that economics is better at the multi-disciplinary stuff than the rest of the soft science. And it's also my view that it's still lousy, and I'd like to discuss this failure in this talk.

As I talk about strengths and weaknesses in academic economics, one interesting fact you are entitled to know is that I never took a course in economics. And with this striking lack of credentials, you may wonder why I have the chutzpah to be up here giving this talk. The answer is I have a black belt in chutzpah. I was born with it. Some people, like some of the women I know, have a black belt in spending. They were born with that. But what they gave me was a black belt in chutzpah.

But I come from two peculiar strands of experience that may have given me some useful economic insights. One is Berkshire Hathaway and the other is my personal educational history.

Berkshire, of course, has finally gotten interesting. When Warren took over Berkshire, the market capitalization was about ten million dollars. And forty something years later, there are not many more shares outstanding now than there were then, and the market capitalization is about a hundred billion dollars, ten thousand for one. And since that has happened, year after year, in kind of a grind-ahead fashion, with very few failures, it eventually drew some attention, indicating that maybe Warren and I knew something useful in microeconomics.

Non-use of Efficient Market Theory at Berkshire

For a long time there was a Nobel Prize-winning economist who explained Berkshire Hathaway's success as follows:

First, he said Berkshire beat the market in common stock investing through one sigma of luck, because nobody could beat the market except by luck. This hard-form version of efficient market theory was taught in most schools of economics at the time. People were taught that nobody could beat the market. Next the professor went to two sigmas, and three sigmas, and four sigmas, and when he finally got to six sigmas of luck, people were laughing so hard he stopped doing it.

Then he reversed the explanation 180 degrees. He said, "No, it was still six sigmas, but is was six sigmas of skill." Well this very sad history demonstrates the truth of Benjamin Franklin's observation in Poor Richard's Almanac. If you would persuade, appeal to interest and not to reason. The man changed his view when his incentives made him change it, and not before.

I watched the same thing happen at the Jules Stein Eye Institute at UCLA. I asked at one point, why are you treating cataracts only with a totally obsolete cataract operation? And the man said to me, "Charlie, it's such a wonderful operation to teach." (Laughter). When he stopped using that operation, it was because almost all the patients had voted with their feet. Again, appeal to interest and not to reason if you want to change conclusions.

Well, Berkshire's whole record has been achieved without paying one ounce of attention to the efficient market theory in its hard form. And not one ounce of attention to the descendants of that idea, which came out of academic economics and went into corporate finance and morphed into such obscenities as the capital asset pricing model, which we also paid no attention to. I think you'd have to believe in the tooth fairy to believe that you could easily outperform the market by seven-percentage points per annum just by investing in high volatility stocks.

Yet, believe it or not, like the Jules Stein doctor, people once believed this stuff. And the belief was rewarded. And it spread. And many people still believe it. But Berkshire never paid any attention to it. And now I think the world is coming our way and the idea of perfection in all market outcomes is going the way of the DoDo.

It was always clear to me that the stock market couldn't be perfectly efficient, because as a teenager, I'd been to the racetrack in Omaha where they had the parimutuel system. And it was quite obvious to me that if the house takes the croupier's take, was 17%, some people consistently lost a lot less then 17% of all their bets, and other people consistently lost more than 17% of all their bets. So the parimutuel system in Omaha had no perfect efficiency. And so I

didn't accept the argument that the stock market was always perfectly efficient in creating rational prices.

Indeed, there's been some documented cases since, of people getting so good at understanding horses and odds, that they actually are able to beat the house in off-track betting. There aren't many people who can do that, but there are a few people in America who can.

Personal Multidisciplinary Education

Next, my personal education history is interesting because its deficiencies and my peculiarities eventually created advantages. For some odd reason, I had an early and extreme multidisciplinary cast of mind. I couldn't stand reaching for a small idea in my own discipline when there was a big idea right over the fence in somebody else's discipline. So I just grabbed in all directions for the big ideas that would really work. Nobody taught me to do that; I was just born with that yen. I also was born with a huge craving for synthesis. And when it didn't come easily, which was often, I would rag the problem, and then when I failed I would put it aside and I'd come back to it and rag it again. It took me 20 years to figure out how and why the Reverend Moon's conversion methods worked. But the psychology departments haven't figured it out yet, so I'm ahead of them.

But anyway, I have this tendency to want to rag the problems. Because WW II caught me. I drifted into some physics, and the Air Corps sent me to Caltech where I did a little more physics as part of being made into a meteorologist. And there, at a very young age, I absorbed what I call the fundamental full attribution ethos of hard science. And that was enormously useful to me. Let me explain that ethos.

Under this ethos, you've got to know all the big ideas in all the disciplines less fundamental than your own. You can never make any explanation, which can be made in a more fundamental way, in any other way than the most fundamental way. And you always take with full attribution to the most fundamental ideas that you are required to use. When you're using physics, you say you're using physics. When you're using biology, you say you're using biology. And so on and so on. I could early see that that ethos would act as a fine organizing system for my thought. And I strongly suspected that it would work really well in the soft sciences as well as the hard sciences, so I just grabbed it and used it all through my life in soft science as well as hard science. That was a very lucky idea for me.

Let me explain how extreme that ethos is in hard science. There is a constant, one of the fundamental constants in physics, known as Boltzmann's constant. You probably all know it very well. And the interesting thing about Boltzmann's constant is that Boltzmann didn't discover it. So why is Boltzmann's constant now named for Boltzmann? Well, the answer was that Boltzmann derived that constant from basic physics in a more fundamental way than the poor forgotten fellow who found the constant in the first place in some less fundamental way. The ethos of hard science is so strong in favor of reductionism to the more fundamental body of knowledge that you can wash the discoverer right out of history when somebody else handles his discovery in a more fundamental way. I think that is correct. I think Boltzmann's constant should be named for Boltzmann.

At any rate, in my history and Berkshire's history Berkshire went on and on into considerable economic success, while ignoring the hard form efficient markets doctrine once very popular in academic economics and ignoring the descendants of that doctrine in corporate finance, where the results became even sillier than they were in the economics. This naturally encouraged me.

Finally, with my peculiar history, I'm also bold enough to be here today, because at least when I was young I wasn't a total klutz. For one year at the Harvard Law School, I was ranked second in my group of about a thousand, and I always figured that, while there were always a lot of people much smarter than I was, I didn't have to hang back totally in the thinking game.

The Obvious Strengths of Academic Economics

Let me begin by discussing the obvious strengths of academic economics. The first obvious strength, and this is true of lot of places that get repute, is that it was in the right place at the right time. Two hundred years ago, aided by the growth of technology and the growth of other developments in the civilization, the real output per capita of the civilized world started going up at about 2% per annum, compounded. And before that, for the previous thousands of years, it had gone up at a rate that hovered just a hair's breadth above zero. And, of course, economics grew up amid this huge success. Partly it helped the success, and partly it explained it. So, naturally, academic economics grew. And lately with the collapse of all the communist economies, as the free market economies or partially free market economies flourished, that added to the reputation of economics. Economics has been a very favorable place to be if you're in academia.

Economics was always more multidisciplinary than the rest of soft science. It just reached out and grabbed things as it needed to. And that tendency to just grab whatever you need from the rest of knowledge if you're an economist has reached a fairly high point in Mankiw's [post.economics.harvard.edu/faculty/mankiw/mankiw.html] new textbook [Principles of Economics, www.amazon.com/exec/obidos/ASIN/0324168624/tilsoncapitalpar]. I checked out that textbook. I must have been one of the few businessmen in America that bought it immediately when it came out because it had gotten such a big advance. I wanted to figure out what the guy was doing where he could get an advance that great. So this is how I happened to riffle through Mankiw's freshman textbook. And there I found laid out as principles of economics: opportunity cost is a superpower, to be used by all people who have any hope of getting the right answer. Also, incentives are superpowers.

And lastly, the tragedy of the commons model, popularized by UCSB's Garrett Hardin [www.es.ucsb.edu/faculty/hardin.php; died 9/03]. Hardin caused the delightful introduction into economics – alongside Smith's beneficent invisible hand – of Hardin's wicked evildoing invisible foot. Well, I thought that the Hardin model made economics more complete, and I knew when Hardin introduced me to his model, the Tragedy of the Commons [www.garretthardinsociety.org/articles/art_tragedy_of_the_commons.html], that it would be in the economics textbooks eventually. And, low and behold, it finally made it about 20 years later. And it's right for Mankiw to reach out into other disciplines and grab Hardin's model and anything else that works well.

Another thing that helped economics is that from the beginning it attracted the best brains in soft science. Its denizens also interacted more with the practical world than was at all common in soft science and the rest of academia, and that resulted in very creditable outcomes like the three cabinet appointments of economics PhD George Schultz and the cabinet appointment of Larry Summers. So this has been a very favored part of academia.

Also, economics early on attracted some of the best writers of language in the history of the earth. You start out with Adam Smith. Adam Smith was so good a thinker, and so good a writer, that in his own time, Emmanuel Kant, then the greatest intellectual in Germany, simply announced that there was nobody in Germany to equal Adam Smith. Well Voltaire, being an even more pithy speaker than Kant, which wouldn't be that hard, immediately said, "Oh well, France doesn't have anybody who can even be compared to Adam Smith." So economics started with some very great men and great writers.

And then there have been later great writers like John Maynard Keynes, whom I quote all the time, and who has added a great amount of illumination to my life. And finally, even in the present era, if you take Paul Krugman [www.nytimes.com/top/opinion/editorialsandoped/oped/columnists/paulkrugman/index.html] and read his essays, you will be impressed by his fluency. I can't stand his politics; I'm on the other side. But I love this man's essays. I think Paul Krugman is one of the best essayists alive. And so economics has constantly attracted these fabulous writers. And they are so good that they have this enormous influence far outside their economic discipline, and that's very uncommon in other academic departments.

Okay, now it's time to extend criticism, instead of praise. We've recognized that economics is better than other soft-science academic departments in many ways. And one of the glories of civilization. Now it's only fair that we outline a few things that are wrong with academic economics.

What's Wrong with Economics

1) Fatal Unconnectedness, Leading To "Man With A Hammer Syndrome," Often Causing Overweighing What Can Be Counted

I think I've got eight, no nine objections, some being logical subdivisions of a big general objection. The big general objection to economics was the one early described by Alfred North Whitehead when he spoke of the fatal unconnectedness of academic disciplines, wherein each professor didn't even know the models of the other disciplines, much less try to synthesize those disciplines with his own.

I think there's a modern name for this approach that Whitehead didn't like, and that name is bonkers. This is a perfectly crazy way to behave. Yet economics, like much else in academia, is too insular.

The nature of this failure is that it creates what I always call, "man with a hammer syndrome." And that's taken from the folk saying: To the man with only a hammer, every problem looks pretty much like a nail. And that works marvelously to gum up all professions, and all departments of academia, and indeed most practical life. The only antidote for being an absolute

klutz due to the presence of a man with a hammer syndrome is to have a full kit of tools. You don't have just a hammer. You've got all the tools. And you've got to have one more trick. You've got to use those tools checklist-style, because you'll miss a lot if you just hope that the right tool is going to pop up unaided whenever you need it. But if you've got a full list of tools, and go through them in your mind, checklist-style, you will find a lot of answers that you won't find any other way. So limiting this big general objection that so disturbed Alfred North Whitehead is very important, and there are mental tricks that help do the job.

Overweighing what can be counted

A special version of this "man with a hammer syndrome" is terrible, not only in economics but practically everywhere else, including business. It's really terrible in business. You've got a complex system and it spews out a lot of wonderful numbers that enable you to measure some factors. But there are other factors that are terribly important, [yet] there's no precise numbering you can put to these factors. You know they're important, but you don't have the numbers. Well practically everybody (1) overweighs the stuff that can be numbered, because it yields to the statistical techniques they're taught in academia, and (2) doesn't mix in the hard-to-measure stuff that may be more important. That is a mistake I've tried all my life to avoid, and I have no regrets for having done that.

The late, great, Thomas Hunt Morgan [www.nobel.se/medicine/articles/lewis/], who was one of greatest biologists who ever lived, when he got to Caltech, had a very interesting, extreme way of avoiding some mistakes from overcounting what could be measured, and undercounting what couldn't. At that time there were no computers and the computer substitute then available to science and engineering was the Frieden calculator, and Caltech was full of Frieden calculators. And Thomas Hunt Morgan banned the Frieden calculator from the biology department. And when they said, "What the hell are you doing, Mr. Morgan?," He said, "Well, I am like a guy who is prospecting for gold along the banks of the Sacramento River in 1849. With a little intelligence, I can reach down and pick up big nuggets of gold. And as long as I can do that, I'm not going to let any people in my department waste scarce resources in placer mining." And that's the way Thomas Hunt Morgan got through life.

I've adopted the same technique, and here I am in my 80th year. I haven't had to do any placer mining yet. And it begins to look like I'm going to get all the way through, as I'd always hoped, without doing any of that damned placer mining. Of course if I were a physician, particularly an academic physician, I'd have to do the statistics, do the placer mining. But it's amazing what you can do in life without the placer mining if you've got a few good mental tricks and just keep ragging the problems the way Thomas Hunt Morgan did.

2) Failure To Follow The Fundamental Full Attribution Ethos of Hard Science

What's wrong with the way Mankiw does economics is that he grabs from other disciplines without attribution. He doesn't label the grabbed items as physics or biology or psychology, or game theory, or whatever they really are, fully attributing the concept to the basic knowledge from which it came. If you don't do that, it's like running a business with a sloppy filing system. It reduces your power to be as good as you can be. Now Mankiw is so smart he does pretty well even when his technique is imperfect. He got the largest advance any textbook writer ever got.

But, nonetheless he'd be better if he had absorbed this hard science ethos that I say has been so helpful to me.

I have names for Mankiw's approach, grabbing whatever you need without attribution. Sometimes I call it "take what you wish," and sometimes I call it "Kipplingism." And when I call it Kipplingism, I'm reminding you of Kippling's stanza of poetry, which went something like this: "When Homer smote his blooming lyre, he'd heard men sing by land and sea, and what he thought he might require, he went and took, the same as me." Well that's the way Mankiw does it. He just grabs. This is much better than not grabbing. But it is much worse than grabbing with full attribution and full discipline, using all knowledge plus extreme reductionism where feasible.

3) Physics Envy

The third weakness that I find in economics is what I call physics envy. And of course, that term has been borrowed from penis envy as described by one of the world's great idiots, Sigmund Freud. But he was very popular in his time, and the concept got a wide vogue.

Washington Post case study

One of the worst examples of what physics envy did to economics was cause adaptation and hard-form efficient market theory. And then when you logically derived consequences from this wrong theory, you would get conclusions such as: it can never be correct for any corporation to buy its own stock. Because the price by definition is totally efficient, there could never be any advantage. QED. And they taught this theory to some partner at McKinsey when he was at some school of business that had adopted this crazy line of reasoning from economics, and the partner became a paid consultant for the Washington Post. And Washington Post stock was selling at a fifth of what an orangutan could figure was the plain value per share by just counting up the values and dividing. But he so believed what he'd been taught in graduate school that he told the Washington Post they shouldn't buy their own stock. Well, fortunately, they put Warren Buffett on the Board, and he convinced them to buy back more than half of the outstanding stock, which enriched the remaining shareholders by much more than a billion dollars. So, there was at least one instance of a place that quickly killed a wrong academic theory.

It's my view that economics could avoid a lot of this trouble that comes from physics envy. I want economics to pick up the basic ethos of hard science, the full attribution habit, but not the craving for an unattainable precision that comes from physics envy. The sort of precise reliable formula that includes Boltzmann's constant is not going to happen, by and large, in economics. Economics involves too complex a system. And the craving for that physics-style precision does little but get you in terrible trouble, like the poor fool from McKinsey.

Einstein and Sharon Stone

I think that economists would be way better off if they paid more attention to Einstein and Sharon Stone. Well, Einstein is easy because Einstein is famous for saying, "Everything should be made as simple as possible, but no more simple." Now, the saying is a tautology, but it's very useful, and some economist – it may have been Herb Stein – had a similar tautological saying that I dearly love: "If a thing can't go on forever, it will eventually stop."

Sharon Stone contributed to the subject because someone once asked her if she was bothered by penis envy. And she said, "absolutely not, I have more trouble than I can handle with what I've got." (Laughter).

When I talk about this false precision, this great hope for reliable, precise formulas, I am reminded of Arthur Laffer, who's in my political party, and who is one of the all-time horses' asses when it comes to doing economics. His trouble is his craving for false precision, which is not an adult way of dealing with his subject matter.

The situation of people like Laffer reminds me of a rustic legislator – and this really happened in America. I don't invent these stories. Reality is always more ridiculous than what I'm going to tell you. At any rate, this rustic legislator proposed a new law in his state. He wanted to pass a law rounding Pi to an even 3.2 so it would be easier for the school children to make the computations. Well, you can say that this is too ridiculous, and it can't be fair to liken economics professors like Laffer to a rustic legislator like this. I say I'm under-criticizing the professors. At least when this rustic legislature rounded Pi to an even number, the error was relatively small. But once you try to put a lot of false precision into a complex system like economics, the errors can compound to the point where they're worse than those of the McKinsey partner when he was incompetently advising the Washington Post. So, economics should emulate physics' basic ethos, but its search for precision in physics–like formulas is almost always wrong in economics.

4) Too Much Emphasis on Macroeconomics

My fourth criticism is that there's too much emphasis on macroeconomics and not enough on microeconomics. I think this is wrong. It's like trying to master medicine without knowing anatomy and chemistry. Also, the discipline of microeconomics is a lot of fun. It helps you correctly understand macroeconomics. And it's a perfect circus to do. In contrast, I don't think macroeconomics people have all that much fun. For one thing they are often wrong because of extreme complexity in the system they wish to understand.

Case study: Nebraska Furniture Mart's new store in Kansas City

Let me demonstrate the power of microeconomics by solving two microeconomic problems. One simple and one a little harder. The first problem is this: Berkshire Hathaway just opened a furniture and appliance store in Kansas City [www.nfm.com/store_kansascity.asp]. At the time Berkshire opened it, the largest selling furniture and appliance store in the world was another Berkshire Hathaway store, selling $350 million worth of goods per year. The new store in a strange city opened up selling at the rate of more than $500 million a year. From the day it opened, the 3,200 spaces in the parking lot were full. The women had to wait outside the ladies restroom because the architects didn't understand biology. (Laughter). It's hugely successful.

Well, I've given you the problem. Now, tell me what explains the runaway success of this new furniture and appliance store, which is outselling everything else in the world? (Pause). Well, let me do it for you. Is this a low-priced store or a high-priced store? (Laughter). It's not going to have a runaway success in a strange city as a high-priced store. That would take time. Number two, if it's moving $500 million worth of furniture through it, it's one hell of a big store,

furniture being as bulky as it is. And what does a big store do? It provides a big selection. So what could this possibly be except a low-priced store with a big selection?

But, you may wonder, why wasn't it done before, preventing its being done first now? Again, the answer just pops into your head: it costs a fortune to open a store this big. So, nobody's done it before. So, you quickly know the answer. With a few basic concepts, these microeconomic problems that seem hard can be solved much as you put a hot knife through butter. I like such easy ways of thought that are very remunerative. And I suggest that you people should also learn to do microeconomics better.

Case study: Les Schwab Tires

Now I'll give you a harder problem. There's a tire store chain in the Northwest, which has slowly succeeded over 50 years, the Les Schwab tire store chain [www.lesschwab.com/]. It just ground ahead. It started competing with the stores that were owned by the big tire companies that made all the tires, the Goodyears and so forth. And, of course, the manufacturers favored their own stores. Their "tied stores" had a big cost advantage. Later, Les Schwab rose in competition with the huge price discounters like Costco and Sam's Club and before that Sears Roebuck and so forth. And yet here is Schwab now, with hundreds of millions of dollars in sales. And here's Les Schwab in his 80s, with no education, having done the whole thing. How did he do it? (Pause). I don't see a whole lot of people looking like a light bulb has come on. Well, let's think about it with some microeconomic fluency.

Is there some wave that Schwab could have caught? The minute you ask the question, the answer pops in. The Japanese had a zero position in tires and they got big. So this guy must have ridden that wave some in the early times. Then the slow following success has to have some other causes. And what probably happened here, obviously, is this guy did one hell of a lot of things right. And among the things that he must have done right is he must have harnessed what Mankiw calls the superpower of incentives. He must have a very clever incentive structure driving his people. And a clever personnel selection system, etc. And he must be pretty good at advertising. Which he is. He's an artist. So, he had to get a wave in Japanese tire invasion, the Japanese being as successful as they were. And then a talented fanatic had to get a hell of a lot of things right, and keep them right with clever systems. Again, not that hard of an answer. But what else would be a likely cause of the peculiar success?

We hire business school graduates and they're no better at these problems than you were. Maybe that's the reason we hire so few of them.

Causes of problem-solving success

Well, how did I solve those problems? Obviously I was using a simple search engine in my mind to go through checklist-style, and I was using some rough algorithms that work pretty well in a great many complex systems, and those algorithms run something like this: Extreme success is likely to be caused by some combination of the following factors:

A) Extreme maximization or minimization of one or two variables. Example, Costco or our furniture and appliance store.

B) Adding success factors so that a bigger combination drives success, often in non-linear fashion, as one is reminded by the concept of breakpoint and the concept of critical mass in physics. Often results are not linear. You get a little bit more mass, and you get a lollapalooza result. And of course I've been searching for lollapalooza results all my life, so I'm very interested in models that explain their occurrence.

C) An extreme of good performance over many factors. Example, Toyota or Les Schwab.

D) Catching and riding some sort of big wave. Example, Oracle. By the way, I put down Oracle before I knew that the Oracle CFO was a big part of the proceedings here today.

Generally I recommend and use in problem solving cut-to-the quick algorithms, and I find you have to use them both forward and backward. Let me give you an example. I irritate my family by giving them little puzzles, and one of the puzzles that I gave my family not very long ago was when I said, "There's an activity in America, with one-on-one contests, and a national championship. The same person won the championship on two occasions about 65 years apart." "Now," I said, "name the activity," (Pause). Again, I don't see a lot of light bulbs going on. And in my family not lot of light bulbs were flashing. But I have a physicist son who has been trained more in the type of thinking I like. And he immediately got the right answer, and here's the way he reasoned:

> It can't be anything requiring a lot of hand-eye coordination. Nobody 85 years of age is going to win a national billiards tournament, much less a national tennis tournament. It just can't be. Then he figured it couldn't be chess, which this physicist plays very well, because it's too hard. The complexity of the system, the stamina required are too great. But that led into checkers. And he thought, "Ah ha! There's a game where vast experience might guide you to be the best even though you're 85 years of age."

And sure enough that was the right answer.

Anyway, I recommend that sort of mental trickery to all of you, flipping one's thinking both backward and forward. And I recommend that academic economics get better at very small scale microeconomics as demonstrated here.

5) Too Little Synthesis in Economics

My fifth criticism is there is too little synthesis in economics. Not only with matter outside traditional economics, but also within economics. I have posed at two different business schools the following problem. I say, "You have studied supply and demand curves. You have learned that when you raise the price, ordinarily the volume you can sell goes down, and when you reduce the price, the volume you can sell goes up. Is that right? That's what you've learned?" They all nod yes. And I say, "Now tell me several instances when, if you want the physical volume to go up, the correct answer is to increase the price?" And there's this long and ghastly pause. And finally, in each of the two business schools in which I've tried this, maybe one person in fifty could name one instance. They come up with the idea that occasionally a higher price acts as a rough indicator of quality and thereby increases sales volumes.

This happened in the case of my friend Bill Ballhaus. When he was head of Beckman Instruments it produced some complicated product where if it failed it caused enormous damage to the purchaser. It wasn't a pump at the bottom of an oil well, but that's a good mental example. And he realized that the reason this thing was selling so poorly, even though it was better than anybody else's product, was because it was priced lower. It made people think it was a low quality gizmo. So he raised the price by 20% or so and the volume went way up.

But only one in fifty can come up with this sole instance in a modern business school – one of the business schools being Stanford, which is hard to get into. And nobody has yet come up with the main answer that I like. Suppose you raise that price, and use the extra money to bribe the other guy's purchasing agent? (Laughter). Is that going to work? And are there functional equivalents in economics – microeconomics – of raising the price and using the extra sales proceeds to drive sales higher? And of course there are zillion, once you've made that mental jump. It's so simple.

One of the most extreme examples is in the investment management field. Suppose you're the manager of a mutual fund, and you want to sell more. People commonly come to the following answer: You raise the commissions, which of course reduces the number of units of real investments delivered to the ultimate buyer, so you're increasing the price per unit of real investment that you're selling the ultimate customer. And you're using that extra commission to bribe the customer's purchasing agent. You're bribing the broker to betray his client and put the client's money into the high-commission product. This has worked to produce at least a trillion dollars of mutual fund sales.

This tactic is not an attractive part of human nature, and I want to tell you that I pretty completely avoided it in my life. I don't think it's necessary to spend your life selling what you would never buy. Even though it's legal, I don't think it's a good idea. But you shouldn't accept all my notions because you'll risk becoming unemployable. You shouldn't take my notions unless you're willing to risk being unemployable by all but a few.

I think my experience with my simple question is an example of how little synthesis people get, even in advanced academic settings, considering economic questions. Obvious questions, with such obvious answers. Yet people take four courses in economics, go to business school, have all these IQ points and write all these essays, but they can't synthesize worth a damn. This failure is not because the professors know all this stuff and they're deliberately withholding it from the students. This failure happens because the professors aren't all that good at this kind of synthesis. They were trained in a different way. I can't remember if it was Keynes or Galbraith who said that economics professors are most economical with ideas. They make a few they learned in graduate school last a lifetime. (Laughter).

The second problem with synthesis

The second interesting problem with synthesis involves two of the most famous examples in the economics. Number one is Ricardo's principle of comparative advantage in trade, and the other is Adam Smith's pin factory. And both of these, of course, work to vastly increase economic output per person, and they're similar in that each somehow directs functions into the hands of people who are very good at doing the functions. Yet they're radically different examples in that

one of them is the ultimate example of central planning, the pin factory, where the whole system was planned by somebody, while the other example, Ricardo's, happens automatically as a natural consequence of trade.

And, of course, once you get into the joys of synthesis, you immediately think. "Do these things interact?" Of course they interact. Beautifully. And that's one of the causes of the power of a modern economic system. I saw an example of that kind of interaction years ago. Berkshire had this former savings and loan company, and it had made this loan on a hotel right opposite the Hollywood Park Racetrack. In due time the neighborhood changed and it was full of gangs, pimps, and dope dealers. They tore copper pipe out of the wall for dope fixes, and there were people hanging around the hotel with guns, and nobody would come. We foreclosed on it two or three times, and the loan value went down to nothing. We seemed to have an insolvable economic problem -- a microeconomic problem.

Now we could have gone to McKinsey, or maybe a bunch of professors from Harvard, and we would have gotten a report about 10 inches thick about the ways we could approach this failing hotel in this terrible neighborhood. But instead, we put a sign on the property that said: "For sale or rent." And in came, in response to that sign, a man who said, "I'll spend $200,000 fixing up your hotel, and buy it at a high price on credit, if you can get zoning so I can turn the parking lot into a putting green." "You've got to have a parking lot in a hotel," we said. "What do you have in mind?" He said. "No, my business is flying seniors in from Florida, putting them near the airport, and then letting them go out to Disneyland and various places by bus and coming back. And I don't care how bad the neighborhood is going to be because my people are self-contained behind walls. All they have to do is get on the bus in the morning and come home in the evening, and they don't need a parking lot; they need a putting green." So we made the deal with the guy. The whole thing worked beautifully, and the loan got paid off, and it all worked out.

Obviously that's an interaction of Ricardo and the pin factory examples. The odd system that this guy had designed to amuse seniors was pure pin factory, and finding the guy with this system was pure Ricardo. So these things are interacting.

Well, I've taken you part way through the synthesis. It gets harder when you want to figure out how much activity should be within private firms, and how much should be within the government, and what are the factors that determine which functions are where, and why do the failures occur, and so on and so on.

It's my opinion that anybody with a high IQ who graduated in economics ought to be able to sit down and write a ten-page synthesis of all these ideas that's quite persuasive. And I would bet a lot of money that I could give this test in practically every economics department in the country, and get a perfectly lousy bunch of synthesis. They'd give me Ronald Coase [www.coase.org/aboutronaldcoase.htm]. They'd talk about transaction costs. They'd click off a little something that their professors gave them and spit it back. But in terms of really understanding how it all fits together, I would confidently predict that most people couldn't do it very well.

By the way, if any of you want to try and do this, go ahead. I think you'll find it hard. In this connection, one of the interesting things that I want to mention is that Max Planck [www-gap.dcs.st-and.ac.uk/~history/Mathematicians/Planck.html], the great Nobel laureate who found Planck's Constant, tried once to do economics. He gave it up. Now why did Max Planck, one of the smartest people who ever lived, give up economics? The answer is, he said, "It's too hard. The best solution you can get is messy and uncertain." It didn't satisfy Planck's craving for order, and so he gave it up. And if Max Planck early on realized he was never going to get perfect order, I will confidently predict that all of the rest of you are going to have exactly the same result.

By the way there's a famous story about Max Planck which is apocryphal: After he won his prize, he was invited to lecture everywhere, and he had this chauffeur that drove him around to give public lectures all through Germany. And the chauffeur memorized the lecture, and so one day he said, "Gee Professor Planck, why don't you let me try it as we switch places?" And so he got up and gave the lecture. At the end of it some physicist stood up and posed a question of extreme difficulty. But the chauffeur was up to it. "Well," he said, "I'm surprised that a citizen of an advanced city like Munich is asking so elementary a question, so I'm going to ask my chauffeur to respond." (Laughter).

6) Extreme and Counterproductive Psychological Ignorance

All right, I'm down to the sixth main defect, and this is a subdivision of the lack of adequate multidisciplinarity: Extreme and counterproductive psychological ignorance in economics. Here I want to give you a very simple problem. I specialize in simple problems.

You own a small casino in Las Vegas. It has fifty standard slot machines. Identical in appearance, they're identical in the function. They have exactly the same payout ratios. The things that cause the payouts are exactly the same. They occur in the same percentages. But there's one machine in this group of slot machines that, no matter where you put it among the fifty, in fairly short order, when you go to the machines at the end of the day, there will be 25% more winnings from this one machine than from any other machine. Now surely I'm not going to have a failure here. What is different about that heavy winning machine? (Silence) Can anybody do it?

Male: More people play it.

Charles Munger: No, no, I want to know why more people play it. What's different about that machine is people have used modern electronics to give a higher ratio of near misses. That machine is going bar, bar, lemon. Bar, bar, grapefruit, way more often than normal machines, and that will cause heavier play. How do you get an answer like that? Easy. Obviously, there's a psychological cause: That machine is doing something to trigger some basic psychological response.

If you know the psychological factors, if you've got them on a checklist in your head, you just run down the factors, and, boom!, you get to one that must explain this occurrence. There isn't any other way to do it effectively. These answers are not going to come to people who don't learn these mental tricks. If you want to go through life like a one legged man in an ass-kicking

contest, why be my guest. But if you want to succeed, like a strong man with two legs, you have to pick up these tricks, including doing economics while knowing psychology.

In this vein, I next want to mention a strange Latin American case of a dysfunctional economy that got fixed. In this little subdivision of Latin America, a culture had arisen wherein everybody stole everything. They embezzled from the company, they stole everything that was loose in the community. And of course, the economy came practically to a halt. And this thing got fixed. Now where did I read about this case? I'll give you a hint. It wasn't in the annals of economics. I found this case in the annals of psychology. Clever people went down and used a bunch of psychological tricks. And they fixed it.

Well, I think there's no excuse if you're an economist, when there are wonderful cases like that of the dysfunctional economy becoming fixed, and these simple tricks that solve so many problems, and you don't know how to do the fixes and understand the problems. Why be so ignorant about psychology that you don't even know psychology's tricks that will fix your own dysfunctional economic systems?

Here I want to give you an extreme injunction. This is even tougher than the fundamental organizing ethos of hard science. This has been attributed to Samuel Johnson [justus.anglican.org/resources/bio/20.html]. He said in substance that if an academic maintains in place an ignorance that can be easily removed with a little work, the conduct of the academic amounts to treachery. That was his word, "treachery." You can see why I love this stuff. He says you have a duty if you're an academic to be as little of a klutz as you can possibly be, and therefore you have got to keep grinding out of your system as much removable ignorance as you can remove.

7) Too Little Attention to Second and Higher Order Effects

On to the next one the seventh defect: Too little attention in economics to second order and even higher order effects. This defect is quite understandable, because the consequences have consequences, and the consequences of the consequences have consequences, and so on. It gets very complicated. When I was a meteorologist I found this stuff very irritating. And economics makes meteorology look like a tea party.

Mispredicting Medicare costs

Extreme economic ignorance was displayed when various experts, including Ph D. economists, forecast the cost of the original Medicare law. They did simple extrapolations of past costs.

Well the cost forecast was off by a factor of more than 1000%. The cost they projected was less than 10% of the cost that happened. Once they put in place all these new incentives, the behavior changed in response to the incentives, and the numbers became quite different from their projection. And medicine invented new and expensive remedies, as it was sure to do. How could a great group of experts make such a silly forecast? Answer: They over simplified to get easy figures, like the rube rounding Pi to 3.2! They chose not to consider effects of effects on effects, and so on.

Investing in textile looms

One good thing about this common form of misthinking from the viewpoint of academia, is that business people are even more foolish about microeconomics. The business version of the Medicare-type insanity is when you own a textile plant and a guy comes in and says, "Oh, isn't this wonderful? They invented a new loom. It'll pay for itself in three years at current prices because it adds so much efficiency to the production of textiles." And you keep buying these looms for 20 years, and their equivalent, and you keep making 4% on capital, you never go anywhere. And the answer is, it wasn't that technology didn't work, it's that the laws of economics caused the benefit from the new looms to go to the people that bought the textiles, not the guy that owned the textile plant. How could anybody not know that if he'd taken freshmen economics or been through business school? I think the schools are doing a lousy job. Otherwise such insanities wouldn't happen so often.

Usually, I don't use formal projections. I don't let people do them for me because I don't like throwing up on the desk (laughter), but I see them made in a very foolish way all the time, and many people believe in them, no matter how foolish they are. It's an effective sales technique in America to put a foolish projection on a desk.

And if you're an investment banker, it's an art form. I don't read their projections either. Once Warren and I bought a company and the seller had a big study done by an investment banker, it was about this thick. We just turned it over as if it were a diseased carcass. He said, "We paid $2 million for that." I said, "We don't use them. Never look at them."

Workman's comp madness

Anyway, as the Medicare example showed, all human systems are gamed, for reasons rooted deeply in psychology, and great skill is displayed in the gaming because game theory has so much potential. That's what's wrong with the workman's comp system in California. Gaming has been raised to an art form. In the course of gaming the system, people learn to be crooked. Is this good for civilization? Is it good for economic performance? Hell no. The people who design easily–gameable systems belong in the lowest circle of hell.

I've got a friend whose family controls about 8% of the truck trailer market. He just closed his last factory in California and he had one in Texas that was even worse. The workman's comp cost in his Texas plant got to be about 30% of payroll. Well, there's no such profit in making truck trailers. He closed his plant and moved it to Ogden, Utah, where a bunch of believing Mormons are raising big families and don't game the workman's comp system. The workman's comp expense is 2% of payroll.

Are the Latinos who were peopling his plant in Texas intrinsically dishonest or bad compared to the Mormons? No. It's just the incentive structure that so rewards all this fraud is put in place by these ignorant legislatures, many members of which have been to law school, and they just don't think about what terrible things they're doing to the civilization because they don't take into account the second order effects and the third order effects in lying and cheating. So, this happens everywhere, and when economics is full of it, it is just like the rest of life.

Niederhoffering the curriculum

There was a wonderful example of gaming a human system in the career of Victor Niederhoffer [www.squashtalk.com/profiles/niederhoffer.htm] in the Economics Department of Harvard. Victor Niederhoffer was the son of a police lieutenant, and he needed to get A's at Harvard. But he didn't want to do any serious work at Harvard, because what he really liked doing was, one, playing world-class checkers; two, gambling in high-stakes card games, at which he was very good, all hours of the day and night; three, being the squash champion of the United States, which he was for years; and, four, being about as good a tennis player as a part-time tennis player could be.

This did not leave much time for getting A's at Harvard so he went into the Economics Department. You'd think he would have chosen French poetry. But remember, this was a guy who could play championship checkers. He thought he was up to outsmarting the Harvard Economics Department. And he was. He noticed that the graduate students did most of the boring work that would otherwise go to the professors, and he noticed that because it was so hard to get to be a graduate student at Harvard, they were all very brilliant and organized and hard working, as well as much needed by grateful professors.

And therefore, by custom, and as would be predicted from the psychological force called reciprocity tendency, in a really advanced graduate course, the professors always gave an A. So Victor Niederhoffer signed up for nothing but the most advanced graduate courses in the Harvard Economics Department, and of course, he got A, after A, after A, after A, and was hardly ever near a class. And for a while, some people at Harvard may have thought it had a new prodigy on its hands. That's a ridiculous story, but the scheme will work still. And Niederhoffer is famous: they call his style "Niederhoffering the curriculum." (Laughter).

This shows how all-human systems are gamed. Another example of not thinking through the consequences of the consequences is the standard reaction in economics to Ricardo's law of comparative advantage giving benefit on both sides of trade. Ricardo came up with a wonderful, non-obvious explanation that was so powerful that people were charmed with it, and they still are, because it's a very useful idea. Everybody in economics understands that comparative advantage is a big deal, when one considers first order advantages in trade from the Ricardo effect. But suppose you've got a very talented ethnic group, like the Chinese, and they're very poor and backward, and you're an advanced nation, and you create free trade with China, and it goes on for a long time.

Now let's follow and second and third order consequences: You are more prosperous than you would have been if you hadn't traded with China in terms of average well-being in the United States, right? Ricardo proved it. But which nation is going to be growing faster in economic terms? It's obviously China. They're absorbing all the modern technology of the world through this great facilitator in free trade, and, like the Asian Tigers have proved, they will get ahead fast. Look at Hong Kong. Look at Taiwan. Look at early Japan. So, you start in a place where you've got a weak nation of backward peasants, a billion and a quarter of them, and in the end they're going to be a much bigger, stronger nation than you are, maybe even having more and better atomic bombs. Well, Ricardo did not prove that that's a wonderful outcome for the former leading nation. He didn't try to determine second order and higher order effects.

If you try and talk like this to an economics professor, and I've done this three times, they shrink in horror and offense because they don't like this kind of talk. It really gums up this nice discipline of theirs, which is so much simpler when you ignore second and third order consequences.

The best answer I ever got on that subject – in three tries – was from George Schultz. He said, "Charlie, the way I figure it is if we stop trading with China, the other advanced nations will do it anyway, and we wouldn't stop the ascent of China compared to us, and we'd lose the Ricardo-diagnosed advantages of trade." Which is obviously correct. And I said, "Well George, you've just invented a new form of the tragedy of the commons. You're locked in this system and you can't fix it. You're going to go to a tragic hell in a handbasket, if going to hell involves being once the great leader of the world and finally going to the shallows in terms of leadership." And he said, "Charlie, I do not want to think about this." I think he's wise. He's even older than I am, and maybe I should learn from him.

8) Not Enough Attention to the Concept of Febezzlement

Okay, I'm now down to my eighth objection: Too little attention within economics to the simplest and most fundamental principle of algebra. Now this sounds outrageous, that economics doesn't do algebra, right? Well, I want to try an example – I may be wrong on this. I'm old and I'm iconoclastic – but I throw it out anyway. I say that economics doesn't pay enough attention to the concept of febezzlement. And that I derive from Galbraith's idea. Galbraith's idea was that, if you have an undisclosed embezzlement, it has a wonderful Keynesian stimulating effect on the economy because the guy who's been embezzled thinks he is as rich as he always was and spends accordingly, and the guy that had stolen the money gets all this new purchasing power. I think that's correct analysis on Galbraith's part. The trouble with his notion is that he's described a minor phenomenon. Because when the embezzlement is discovered, as it almost surely will be, the effect will quickly reverse. So the effect quickly cancels out.

But suppose you paid a lot of attention to algebra, which I guess Galbraith didn't, and you think, "Well, the fundamental principle of algebra is, 'If A is equal to B and B is equal to C, then A is equal to C.'" You've then got a fundamental principle that demands that you look for functional equivalents, all you can find. So suppose you ask the question, "Is there such a thing in economics as a febezzlement?" By the way, Galbraith invented the word "bezzle" to describe the amount of undisclosed embezzlement, so I invented the word "febezzlement": the functional equivalent of embezzlement.

This happened after I asked the question "Is there a functional equivalent of embezzlement?" I came up with a lot of wonderful affirmative answers. Some were in investment management. After all I'm near investment management. I considered the billions of dollars totally wasted in the course of investing common stock portfolios for American owners. As long as the market keep going up, the guy who's wasting all this money doesn't feel it, because he's looking at these steadily rising values. And to the guy who is getting the money for investment advice, the money looks like well earned income, when he's really selling detriment for money, surely the functional equivalent of undisclosed embezzlement. You can see why I don't get invited to many lectures.

So I say, if you look in the economy for febezzlement, the functional equivalent of embezzlement, you'll find some enormously powerful factors. They create some "wealth effect" that is on steroids, compared to the old "wealth effect." But practically nobody thinks as I do, and I quitclaim my idea to any hungry graduate student who has independent means, which he will need before his thesis topic is approved.

9) Not Enough Attention to Virtue and Vice Effects

Okay, my ninth objection: Not enough attention to virtue and vice effects in economics. It has been plain to me since early life that there are enormous virtue effects in economics, and also enormous vice effects. But economists get very uncomfortable when you talk about virtue and vice. It doesn't lend itself to a lot of columns of numbers. But I would argue that there are big virtue effects in economics. I would say that the spreading of double-entry bookkeeping by the Monk, Fra Luca de Pacioli [www-gap.dcs.st-and.ac.uk/~history/Mathematicians/Pacioli.html], was a big virtue effect in economics. It made business more controllable, and it made it more honest. Then the cash register. The cash register did more for human morality than the congregational church. It was a really powerful phenomenon to make an economic system work better, just as, in reverse, system that can be easily defrauded ruins a civilization. A system that's very hard to defraud, like a cash register, helps the economic performance of a civilization by reducing vice, but very few people within economics talk about it in those terms.

Religion

I'll go further: I say economic systems work better when there's an extreme reliability ethos. And the traditional way to get a reliability ethos, at least in past generations in America, was through religion. The religions instilled guilt. We have a charming Irish Catholic priest in our neighborhood and he loves to say, "Those old Jews may have invented guilt, but we perfected it." (Laughter). And this guilt, derived from religion, has been a huge driver of a reliability ethos, which has been very helpful to economic outcomes for man.

Pay for directors and judges

Many bad effects from vice are clear. You've got the crazy booms and crooked promotions – all you have to do is read the paper over the last six months. There's enough vice to make us all choke. And, by the way, everybody's angry about unfair compensation at the top of American corporations, and people should be. We now face various crazy nostrums invented by lawyers which won't give us a fix for unfair compensation, yet a good partial solution is obvious: If directors were significant shareholders who got a pay of zero, you'd be amazed what would happen to unfair compensation of corporate executives as we dampened effects from reciprocity tendency.

A roughly similar equivalent of this no-pay system has been tried in a strange place. In England the lower criminal courts which can send you to prison for a year or fine you substantially, are staffed by lay magistrates. You've got three judges sitting up there, and they all get a pay of zero. Their expenses are reimbursed, but not too liberally. And they work about 40 half-days a year, as volunteers. It's worked beautifully for about 700 years. Able and honest people compete to become magistrates, to perform the duty and get the significance, but no pay.

This is the system Benjamin Franklin, near the end of his life, wanted for U.S. government. He didn't want the high executives of government to be paid, but to be like himself or the entirely unpaid, well-off ministers and rulers of the Mormon Church. And when I see what's happened in California, I'm not sure he wasn't right. At any rate, no one now drifts in Franklin's direction. For one thing, professors – and most of them need money – get appointed directors.

Not a vice that some systems are deliberately made unfair

It is not always recognized that, to function best, morality should sometimes appear unfair, like most worldly outcomes. The craving for perfect fairness causes a lot of terrible problems in system function. Some systems should be made deliberately unfair to individuals because they'll be fairer on average for all of us. I frequently cite the example of having your career over, in the Navy, if your ship goes aground, even if it wasn't your fault. I say the lack of justice for the one guy that wasn't at fault is way more than made up by a greater justice for everybody when every captain of a ship always sweats blood to make sure the ship doesn't go aground. Tolerating a little unfairness to some to get a greater fairness for all is a model I recommend to all of you. But again, I wouldn't put it in your assigned college work if you want to be graded well, particularly in a modern law school wherein there is usually an over-love of fairness-seeking process.

Contributions of vice to bubbles

There are, of course, enormous vice effects in economics. You have these bubbles with so much fraud and folly. The aftermath is frequently very unpleasant, and we've had some of that lately. One of the first big bubbles, of course, was the huge and horrible South Sea bubble in England. And the aftermath was interesting. Many of you probably don't remember what happened after the South Sea Bubble, which caused an enormous financial contraction, and a lot of pain. They banned publicly traded stock in England for decades. Parliament passed a law that said you can have a partnership with a few partners, but you can't have publicly traded stock. And, by the way, England continued to grow without publicly traded stock. The people who are in the business of prospering because there's a lot of stock being traded in casino-like frenzy wouldn't like this example if they studied it enough. It didn't ruin England to have a long period when they didn't have publicly traded shares.

Just as in real estate. We had all the shopping centers and auto dealerships, and so on, we needed for years when we didn't have publicly traded real estate shares. It's a myth that once you've got some capital market, economic considerations demand that it has to be as fast and efficient as a casino. It doesn't.

Paradoxical good contributions from vice; the irremovability of paradox

Another interesting problem is raised by vice effects involving envy. Envy wisely got a very strong condemnation in the laws of Moses. You remember how they laid it on with a trowel: You couldn't covet thy neighbor's ass, you couldn't covet thy neighbor's servant girl, you couldn't covet…--Those old Jews knew how envious people are and how much trouble it caused. They really laid it on hard, and they were right. But Mandeville, [htpp://cepa.newschool.edu/het/profiles/mandev.htm], remember his fable of bees? He

demonstrated convincingly – to me, anyway – that envy was a great driver of proclivity to spend. And so here's this terrible vice, which is forbidden in the Ten Commandments, and here it's driving all these favorable results in economics. There's some paradox in economics that nobody's going to get out.

When I was young, everybody was excited by Godel [www.gap.dcs.st-and.ac.uk/~history/Mathematicians/Godel.html] who came up with proof that you couldn't have a mathematical system without a lot of irritating incompleteness in it. Well, since then my betters tell me that they've come up with more irremovable defects in mathematics and have decided that you're never going to get mathematics without some paradox in it. No matter how hard you work, you're going to have to live with some paradox if you're a mathematician.

Well, if the mathematicians can't get the paradox out of their system when they're creating it themselves, the poor economists are never going to get rid of paradoxes, nor are any of the rest of us. It doesn't matter. Life is interesting with some paradox. When I run into a paradox I think either I'm a total horse's ass to have gotten to this point, or I'm fruitfully near the edge of my discipline. It adds excitement to life to wonder which it is.

Conclusion

Clinging to failed ideas – a horror story

As I conclude, I want to tell one more story demonstrating how awful it is to get a wrong idea from a limited repertoire and just stick to it. And this is the story of Hyman Liebowitz who came to America from the old country. In the new country, as in the old, he tried to make his way in the family trade, which was manufacturing nails. And he struggled and he struggled, and finally his little nail business got to vast prosperity, and his wife said to him, "You are old, Hyman, it's time to go to Florida and turn the business over to our son."

So down he went to Florida, turning his business over to the son, but he got weekly financial reports. And he hadn't been in Florida very long before they turned sharply negative. In fact, they were terrible. So he got on an airplane and he went back to New Jersey, where the factory was. As he left the airport on the way to the factory he saw this enormous outdoor advertising sign lighted up. And there was Jesus, spread out on the cross. And under it was a big legend, "They Used Liebowitz's Nails." So he stormed into the factory and said, "You dumb son! What do you think you're doing? It took me 50 years to create this business!" "Papa," he said, "trust me. I will fix it."

So back he went to Florida, and while he was in Florida he got more reports, and the results kept getting worse. So he got on the airplane again. Left the airport, drove by the sign, looked up at this big lighted sign, and now there's a vacant cross. And, low and behold, Jesus is crumpled on the ground under the cross, and the sign said, "They Didn't Use Liebowitz's Nails." (Laugher).

Well, you can laugh at that. It is ridiculous but it's no more ridiculous than the way a lot of people cling to failed ideas. Keynes said "It's not bringing in the new ideas that's so hard. It's getting rid of the old ones." And Einstein said it better, attributing his mental success to "curiosity, concentration, perseverance and self-criticism." By self-criticism he meant becoming

good at destroying your own best-loved and hardest-won ideas. If you can get really good at destroying your own wrong ideas, that is a great gift.

Repeating the big lesson

Well, it's time to repeat the big lesson in this little talk. What I've urged is the use of a bigger multidisciplinary bag of tricks, mastered to fluency, to help economics and everything else. And I also urged that people not be discouraged by irremovable complexity and paradox. It just adds more fun to the problems. My inspiration again is Keynes: Better roughly right than precisely wrong.

And so I end by repeating what I said once before on a similar occasion. If you skillfully follow the multidisciplinary path, you will never wish to come back. It would be like cutting off your hands.

Well, that's the end. I'll take questions as long as people can endure me.

(Applause)

Q & A

Male: …financial destruction from trading of derivative contracts. Buffett said that the genie's out of the bottle and the hangover may be proportionate to the binge. Would you speculate for us how that scenario can play out? [The question was garbled, but the person asked about derivatives, which Buffett has called "financial weapons of mass destruction."]

Munger: Well, of course, catastrophe predictions have always been quite difficult to make with success. But I confidently predict that there are big troubles to come. The system is almost insanely irresponsible. And what people think are fixes aren't really fixes. It's so complicated I can't do it justice here – but you can't believe the trillions of dollars involved. You can't believe the complexity. You can't believe how difficult it is to do the accounting. You can't believe how big the incentives are to have wishful thinking about values, and wishful thinking about ability to clear.

Running off derivative book is agony and takes time. And you saw what happened when they tried to run off the derivative books at Enron. Its certified net worth vanished. In the derivative books of America there are a lot of reported profits that were never earned and assets that never existed.

And there are large febezzlement effects and some ordinary embezzlement effects that come from derivative activity. And the reversal of these is going to cause pain. How big the pain will be and how well it will be handled, I can't tell you. But you would be disgusted if you had a fair mind and spent a month really delving into a big derivative operation. You would think it was Lewis Carroll [author of Alice in Wonderland]. You would think it was the Mad Hatter's Tea Party. And the false precision of these people is just unbelievable. They make the worst economics professors look like gods. Moreover, there is depravity augmenting the folly. Read the book "F.I.A.S.C.O.", by law professor and former derivatives trader Frank Partnoy, an insider account of depravity in derivative trading at one of the biggest and best regarded Wall

Street firms. The book will turn your stomach. [F.I.A.S.C.O.: The Inside Story of a Wall Street Trader]

Rajneesh Mehta: We'll take one more question. There's a class outside that has to come in. So one more question.

Male: Could you describe Warren's reactions to the advice about the negative reaction that he got from musing about defects of California's Prop 13? Was he shocked, surprised?

Munger: It's hard to shock Warren. He's past 70, he's seen a lot. And his brain works quickly. He generally avoids certain subjects before elections and that is what I am going to do here. (Laughter).

<u>The Great Financial Scandal of 2003</u>
(An Account by Charles T. Munger)

The great financial scandal erupted in 2003 with the sudden, deserved disgrace of Quant Technical Corporation, always called "Quant Tech". By this time Quant Tech was the country's largest pure engineering firm, having become so as a consequence of the contributions of its legendary founder, engineer Albert Berzog Quant.

After 2003, people came to see the Quant Tech story as a sort of morality play, divided into two acts. Act One, the era of the great founding engineer, was seen as a golden age of sound values. Act Two, the era of the founder's immediate successors, was seen as the age of false values with Quant Tech becoming, in the end, a sort of latter day Sodom or Gomorrah.

In fact, as this account will make clear, the change from good to evil did not occur all at once when Quant Tech's founder died in 1982. Much good continued after 1982, and serious evil had existed for many years prior to 1982 in the financial culture in which Quant Tech had to operate.

The Quant Tech story is best understood as a classic sort of tragedy in which a single flaw is inexorably punished by remorseless Fate. The flaw was the country's amazingly peculiar accounting treatment for employee stock options. The victims were Quant Tech and its country. The history of the Great Financial Scandal, as it actually happened, could have been written by Sophocles.

As his life ended in 1982, Albert Berzog Quant delivered to his successors and his Maker a wonderfully prosperous and useful company. The sole business of Quant Tech was designing, for fees, all over the world, a novel type of super-clean and super-efficient small power plant that improved electricity generation.

By 1982 Quant Tech had a dominant market share in its business and was earning $100 million on revenues of $1 billion. It's costs were virtually all costs to compensate technical employees engaged in design work. Direct employee compensation cost amounted to 70% of revenues. Of this 70%, 30% was base salaries and 40% was incentive bonuses being paid out under an elaborate system designed by the founder. All compensation was paid in cash. There were no stock options because the old man had considered the accounting treatment required for stock options to be "weak, corrupt and contemptible," and he no more wanted bad accounting in his business than he wanted bad engineering. Moreover, the old man believed in tailoring his huge incentive bonuses to precise performance standards established for individuals or small groups, instead of allowing what he considered undesirable compensation outcomes, both high and low, such as he believed occurred under other companies' stock option plans.

Yet, even under the old man's system, most of Quant Tech's devoted longtime employees were becoming rich, or sure to get rich. This was happening because the employees were buying Quant Tech stock in the market, just like non-employee

shareholders. The old man had always figured that people smart enough, and self-disciplined enough, to design power plants could reasonably be expected to take care of their own financial affairs in this way. He would sometimes advise an employee to buy Quant Tech stock, but more paternalistic than that he would not become.

By the time the founder died in 1982, Quant Tech was debt free and, except as a reputation-enhancer, really didn't need any shareholders' equity to run its business, no matter how fast revenues grew. However, the old man believed with Ben Franklin that "it is hard for an empty sack to stand upright," and he wanted Quant Tech to stand upright. Moreover, he loved his business and his coworkers and always wanted to have on hand large amounts of cash equivalents so as to be able to maximize work-out or work-up chances if an unexpected adversity or opportunity came along. And so in 1982 Quant Tech had on hand $500 million in cash equivalents, amounting to 50% of revenues.

Possessing a strong balance sheet and a productive culture and also holding a critical mass of expertise in a rapidly changing and rapidly growing business, Quant Tech, using the old man's methods, by 1982 was destined for 20 years ahead to maintain profits at 10% of revenues while revenues increased at 20% per year. After this 20 years, commencing in 2003, Quant Tech's profit margin would hold for a very long time at 10% while revenue growth would slow down to 4% per year. But no one at Quant Tech knew precisely when its inevitable period of slow revenue growth would begin.

The old man's dividend policy for Quant Tech was simplicity itself: He never paid a dividend. Instead, all earnings simply piled up in cash equivalents.

Every truly sophisticated investor in common stocks could see that the stock of cash-rich Quant Tech provided a splendid investment opportunity in 1982 when it sold at a mere 15 times earnings and, despite its brilliant prospects, had a market capitalization of only $1.5 billion. This low market capitalization, despite brilliant prospects, existed in 1982 because other wonderful common stocks were also then selling at 15 times earnings, or less, as a natural consequence of high interest rates then prevailing plus disappointing investment returns that had occurred over many previous years for holders of typical diversified portfolios of common stocks.

One result of Quant Tech's low market capitalization in 1982 was that it made Quant Tech's directors uneasy and dissatisfied right after the old man's death. A wiser board would then have bought in Quant Tech's stock very aggressively, using up all cash on hand and also borrowing funds to use in the same way. However, such a decision was not in accord with conventional corporate wisdom in 1982. And so the directors made a conventional decision. They recruited a new CEO and CFO from outside Quant Tech, in particular from a company that then had a conventional stock option plan for employees and also possessed a market capitalization at 20 times reported earnings, even though its balance sheet was weaker than Quant Tech's and its earnings were growing more slowly than earnings at Quant Tech. Incident to the recruitment of the new executives, it was

made plain that Quant Tech's directors wanted a higher market capitalization, as soon as feasible.

The newly installed Quant Tech officers quickly realized that the company could not wisely either drive its revenues up at an annual rate higher than the rate in place or increase Quant Tech profit margin. The founder had plainly achieved an optimum in each case. Nor did the new officers dare tinker with an engineering culture that was working so well. Therefore, the new officers were attracted to employing what they called "modern financial engineering" which required prompt use of any and all arguably lawful methods for driving up reported earnings, with big, simple changes to be made first.

By a strange irony of fate, the accounting convention for stock options that had so displeased Quant Tech's founder now made the new officers' job very easy and would ultimately ruin Quant Tech's reputation. There was now an accounting convention in the United States that, provided employees were first given options, required that when easily marketable stock was issued to employees at a below-market price, the bargain element for the employees, although roughly equivalent to cash, could not count as compensation expense in determining a company's reported profits. This amazingly peculiar accounting convention had been selected by the accounting profession, over the objection of some of its wisest and most ethical members, because corporate managers, by and large, preferred that their gains from exercising options covering their employers' stock not be counted as expense in determining their employers' earnings. The accounting profession, in making its amazingly peculiar decision, had simply followed the injunction so often followed by persons quite different from prosperous, entrenched accountants. The injunction was that normally followed by insecure and powerless people: "His bread I eat, his song I sing." Fortunately, the income tax authorities did not have the same amazingly peculiar accounting idea as the accounting profession. Elementary common sense prevailed, and the bargain element in stock option exercises was treated as an obvious compensation expense, deductible in determining income for tax purposes.

Quant Tech's new officers, financially shrewd as they were, could see at a glance that , given the amazingly peculiar accounting convention and the sound income-tax rules in place, Quant Tech had a breathtakingly large opportunity to increase its reported profits by taking very simple action. The fact that so large a share of Quant Tech's annual expense was incentive bonus expense provided a "modern financial engineering" opportunity second to none.

For instance, it was mere child's play for the executives to realize that if in 1982 Quant Tech had substituted employee stock option exercise profits for all its incentive bonus expense of $400 million, while using bonus money saved, plus option prices paid, to buy back all shares issued in option exercises and keeping all else the same, the result would have been to drive Quant Tech 1982 reported earnings up by 400% to $500 million from $100 million while shares outstanding remained exactly the same! And so it seemed that the obviously correct ploy for the officers was to start substituting employee stock option exercise profits for incentive bonuses. Why should a group of numerate engineers care

whether their bonuses were in cash of virtually perfect equivalents of cash? Arranging such substitutions, on any schedule desired, seemed like no difficult chore.

However, it was also mere child's play for the new officers to realize that a certain amount of caution and restraint would be desirable in pushing their new ploy. Obviously, if they pushed their new ploy too hard in any single year there might be rebellion from Quant Tech's accountants or undesirable hostility from other sources. This, in turn, would risk killing a goose with a vast ability to deliver golden eggs, at least to the officers. After all, it was quite clear that their ploy would be increasing reported earnings only by adding to real earnings an element of phony earnings – phony in the sense that Quant Tech would enjoy no true favorable economic effect (except temporary fraud-type effect similar to that from overcounting closing inventory) from that part of reported earnings increases attributable to use of the ploy. The new CEO privately called the desirable, cautious approach "wisely restrained falsehood".

Plainly, the new officers saw, it would be prudent to shift bonus payments to employee stock option exercise profits in only a moderate amount per year over many years ahead. They privately called the prudent plan they adopted their "dollop by dollop system" which they believed had four obvious advantages:

> First, a moderate dollop of phony earnings in any single year would be less likely to be noticed than a large dollop.
>
> Second, the large long-term effect from accumulating many moderate dollops of phony earnings over the years would also tend to be obscured in the "dollop by dollop system." As the CFO pithily and privately said: "If we mix only a moderate minority share of turds with the raisins each year, probably no one will recognize what will ultimately become a very large collection of turds."
>
> Third, the outside accountants, once they had blessed a few financial statements containing earnings increases only a minority share of which were phony, would probably find it unendurably embarrassing not to bless new financial statements containing only the same phony proportion of reported earnings increase.
>
> Fourth, the "dollop by dollop system" would tend to prevent disgrace, or something more seriously harmful, for Quant Tech's officers. With virtually all corporations except Quant Tech having ever-more-liberal stock option plans, the officers could always explain that a moderate dollop of shift toward compensation in option-exercise form was needed to help attract or retain employees. Indeed, given corporate culture and stock market enthusiasm likely to exist as a consequence of the strange accounting convention for stock options, this claim would often be true.

With these four advantages, the "dollop by dollop system" seemed so clearly desirable that it only remained for Quant Tech's officers to decide how big to make their annual

dollops of phony earnings. This decision, too, turned out to be easy. The officers first decided upon three reasonable conditions they wanted satisfied:

> First, they wanted to be able to continue their "dollop by dollop system" without major discontinuities for 20 years.
>
> Second, they wanted Quant Tech's reported earnings to go up by roughly the same percentage each year throughout the whole 20 years because they believed that financial analysts, representing institutional investors, would value Quant Tech's stock higher if reported annual earnings growth never significantly varied.
>
> Third, to protect credibility for reported earnings, they never wanted to strain credulity of investors by reporting, even in their 20th year, that Quant Tech was earning more than 40% of revenues from designing power plants.

With these requirements, the math was easy, given the officers assumption that Quant Tech's non-phony earnings and revenues were both going to grow at 20% per year for 20 years. The officers quickly decided to use their "dollop by dollop system" to make Quant Tech's reported earnings increase by 28% per year instead of the 20% that would have been reported by the founder.

And so the great scheme of "modern financial engineering" went forward toward tragedy at Quant Tech. And few disreputable schemes of man have ever worked better in achieving what was attempted. Quant Tech's reported earnings, certified by its accountants, increased regularly at 28% per year. No one criticized Quant Tech's financial reporting except a few people widely regarded as impractical, overly theoretical, misanthropic cranks. It turned out that the founder's policy of never paying dividends, which was continued, greatly helped in preserving credibility for Quant Tech's reports that its earnings were rising steadily at 28% per year. With cash equivalents on hand so remarkably high, the Pavlovian mere-association effects that so often impair reality recognition served well to prevent detection of the phony element in reported earnings.

It was therefore natural, after the "dollop by dollop system" had been in place for a few years, for Quant Tech's officers to yearn to have Quant Tech's reported earnings per share keep going up at 28% per year while cash equivalents grew much faster than they were then growing. This turned out to be a snap. By this time, Quant Tech's stock was selling at a huge multiple of reported earnings, and the officers simply started causing some incremental stock-option exercises that were not matched either by reductions in cash bonuses paid or by repurchases of Quant Tech's stock. This change, the officers easily recognized, was a very helpful revision of their original plan. Not only was detection of the phony element in reported earnings made much more difficult as cash accumulation greatly accelerated, but also a significant amount of Ponzi-scheme or chain-letter effect was being introduced into Quant Tech, with real benefits for present shareholders, including the officers.

At this time the officers also fixed another flaw in their original plan. They saw that as Quant Tech's reported earnings, containing an increasing phony element, kept rising at 28%, Quant Tech's income taxes as a percentage of reported pre-tax earnings kept going lower and lower. This plainly increased chances for causing undesired questions and criticism. This problem was soon eliminated. Many power plants in foreign nations were built and owned by governments, and it proved easy to get some foreign governments to raise Quant Tech's design fees, provided that in each case slightly more than the fee increase was paid back in additional income taxes to the foreign government concerned.

Finally, for 2002, Quant Tech reported $16 billion in earnings on $47 billion of revenues that now included a lot more revenue from interest on cash equivalents than would have been present without net issuances of new stock over the years. Cash equivalents on hand now amounted to an astounding $85 billion, and somehow it didn't seem impossible to most investors that a company virtually drowning in so much cash could be earning the $16 billion it was reporting. The market capitalization of Quant Tech at its peak early in 2003 became $1.4 trillion, about 90 times earnings reported for 2002.

However, all man's desired geometric progressions, if a high rate of growth is chosen, at last come to grief on a finite earth. And the social system for man on earth is fair enough, eventually, that almost all massive cheating ends in disgrace. And in 2003 Quant Tech failed in both ways.

By 2003, Quant Tech's real earning power was growing at only 4% per year after sales growth had slowed to 4%. There was now no way for Quant Tech to escape causing a big disappointment for its shareholders, now largely consisting of institutional investors. This disappointment triggered a shocking decline in the price of Quant Tech stock which went down suddenly by 50%. This price decline, in turn, triggered a careful examination of Quant Tech's financial reporting practices which, at long last, convinced nearly everyone that a very large majority of Quant Tech's reported earnings had long been phony earnings and that massive and deliberate misreporting had gone on for a great many years. This triggered even more price decline for Quant Tech stock until in mid-2003 the market capitalization of Quant Tech was only $140 billion, down 90% from its peak only six months earlier.

A quick 90% decline in the price of the stock of such an important company, that was previously so widely owned and admired, caused immense human suffering, considering the $1.3 trillion in market value that had disappeared. And naturally, with Quant Tech's deserved disgrace, the public and political reaction included intense hatred and revulsion directed at Quant Tech, even though its admirable engineers were still designing the nation's best power plants.

Moreover, the hatred and revulsion did not stop with Quant Tech. It soon spread to other corporations, some of which plainly had undesirable financial cultures different from Quant Tech's only in degree. The public and political hatred, like the behavior that had caused it, soon went to gross excess and fed upon itself. Financial misery spread far

beyond investors into a serious recession like that of Japan in the 1990s following the long period of false Japanese accounting.

There was huge public antipathy to professions following the Great Scandal. The accounting profession, of course, got the most blame. The rule-making body for accountants had long borne the acronym "F.A.S.B." And now nearly everyone said this stood for "Financial Accounts Still Bogus".

Economics professors likewise drew much criticism for failing to blow the whistle on false accounting and for not sufficiently warning about eventual bad macroeconomic effects of widespread false accounting. So great was the disappointment with conventional economists that Harvard's John Kenneth Galbraith received the Nobel Prize in economics. After all, he had once predicted that massive, undetected corporate embezzlement would have a wonderfully stimulating effect on the economy. And people could now see that something very close to what Galbraith had predicted had actually happened in the years preceding 2003 and had thereafter helped create a big, reactive recession.

With Congress and the S.E.C. so heavily peopled by lawyers, and with lawyers having been so heavily involved in drafting financial disclosure documents now seen as bogus, there was a new "lawyer" joke every week. One such was: "The butcher says 'the reputation of lawyers has fallen dramatically', and the check-out clerk replies: "How do you fall dramatically off a pancake?'"

But the hostility to established professions did not stop with accountants, economists and lawyers. There were many adverse "rub-off" effects on reputations of professionals that had always performed well, like engineers who did not understand the financial fraud that their country had made not a permissible option but a legal requirement.

In the end, much that was good about the country, and needed for its future felicity, was widely and unwisely hated.

At this point, action came from a Higher Realm. God himself, who reviews all, changed His decision schedule to bring to the fore the sad case of the Great Financial Scandal of 2003. He called in his chief detective and said, "Smith, bring in for harsh but fair judgment the most depraved of those responsible for this horrible outcome."

But when Smith brought in a group of security analysts who had long and uncritically touted the stock of Quant Tech, the Great Judge was displeased. "Smith," he said, "I can't come down hardest on low-level cognitive error, much of it subconsciously caused by the standard incentive systems of the world."

Next, Smith brought in a group of S.E.C. Commissioners and powerful politicians. "No, no," said the Great Judge, "These people operate in a virtual maelstrom of regrettable forces and can't reasonably be expected to meet the behavioral standard you seek to impose."

Now the chief detective thought he had gotten the point. He next brought in the corporate officers who had practiced their version of "modern financial engineering" at Quant Tech. "You are getting close," said the Great Judge, "but I told you to bring in the most depraved. These officers will, of course, get strong punishment for their massive fraud and disgusting stewardship of the great engineer's legacy. But I want you to bring in the miscreants who will soon be in the lowest circle in Hell, the ones who so easily could have prevented all this calamity."

At last the chief detective truly understood. He remembered that the lowest circle of Hell was reserved for traitors. And so he now brought in from Purgatory a group of elderly persons who, in their days on earth, had been prominent partners in major accounting firms. "Here are your traitors," said the chief detective. "They adopted the false accounting convention for employee stock options. They occupied high positions in one of the noblest professions, which, like Yours, helps make society work right by laying down the right rules. They were very smart and securely placed, and it is inexcusable that they deliberately caused all this lying and cheating that was so obviously predictable. They well knew what they were doing was disastrously wrong, yet they did it anyway. Owing to press of business in Your Judicial System, you made a mistake at first in punishing them so lightly. But now you can send them into the lowest circle in Hell."

Startled by the vehemence and presumption, the Great Judge paused. Then He quietly said: "Well done, my good and faithful servant."

This account is not an implied prediction about 2003. It is a work of fiction. Except in the case of Professor Galbraith, any resemblances to real persons or companies is accidental. It was written in an attempt to focus possibly useful attention on certain modern behaviors and belief systems.

Munger Goes Mental

Charlie Munger, the famed right-hand man of Warren Buffett, gave a brilliant speech last October at the University of California, Santa Barbara. With Munger's permission, Whitney Tilson is publishing a transcript for the first time -- a Motley Fool exclusive! -- and shares the highlights in this column.

By Whitney Tilson
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Berkshire Hathaway's (NYSE: BRK.A)(NYSE: BRK.B) Warren Buffett and Charlie Munger are undoubtedly the greatest investment duo ever, so I think any sensible investor should try to learn as much as possible about these two men and how they achieved their success. In the case of Buffett, it's not hard -- there are many books about him, he's published lengthy annual letters for decades (you can read the last 27 of them for free on Berkshire's website), and he gives speeches and makes public appearances regularly. But Munger is more private; there are only two books about him, he is a far less prolific writer, and rarely gives speeches.

Thus, my heart skipped a beat when a friend gave me a recording of a speech Munger gave to the economics department at the University of California, Santa Barbara last Oct. 3. It's 85 minutes long and entitled, "Academic Economics: Strengths and Faults After Considering Interdisciplinary Needs."

With that kind of title, it sounds like a real snoozer, eh? But it's not. In this speech, Munger applies his famous mental models approach to critiquing how economics is taught and practiced, and I think the lessons he teaches are profound -- both for investors as well as anyone who seeks to be a better, clearer thinker.

I transcribed the speech for my own benefit, but after making such an effort (it took forever, as it's 21 single-spaced pages), I thought that others might be interested in Munger's wisdom, so I sent him a copy and asked if I could publish it. He asked me not to until he'd had a chance to review it and make some edits. He has now done so, so I'm delighted to share it with you: Click here to read it.

In this column, I will share some of the highlights of the speech.

Berkshire's success

Munger started his speech by highlighting his credentials to talk about economics -- namely the extraordinary success of Berkshire Hathaway over the years he and Buffett have been running it (Buffett ran it for a few years before Munger joined him):

> When Warren took over Berkshire, the market capitalization was about ten million dollars. And forty something years later, there are not many more shares outstanding now than there were then, and the market capitalization is about a hundred billion dollars, ten thousand for one. And since that has happened, year

> after year, in kind of a grind-ahead fashion, with very few failures, it eventually drew some attention, indicating that maybe Warren and I knew something useful in microeconomics.

Efficient market theory

Buffett and Munger have always heaped scorn upon the academics who cling to the efficient market theory, unable to distinguish between an obvious truth -- that the market is mostly efficient most of the time -- and obvious nonsense -- that the market is always perfectly efficient all of the time:

> Berkshire's whole record has been achieved without paying one ounce of attention to the efficient market theory in its hard form. And not one ounce of attention to the descendants of that idea, which came out of academic economics and went into corporate finance and morphed into such obscenities as the capital asset pricing model, which we also paid no attention to. I think you'd have to believe in the tooth fairy to believe that you could easily outperform the market by seven-percentage points per annum just by investing in high volatility stocks. Yet…many people still believe it. But Berkshire never paid any attention to it.

Multidisciplinary education and "man with a hammer syndrome"

Over the years, Munger has always preached the importance of learning -- and then using -- all of the big disciplines, such as math, science, psychology, etc. To him, this just came naturally:

> For some odd reason, I had an early and extreme multidisciplinary cast of mind. I couldn't stand reaching for a small idea in my own discipline when there was a big idea right over the fence in somebody else's discipline. So I just grabbed in all directions for the big ideas that would really work. Nobody taught me to do that; I was just born with that yen.

If one doesn't embrace all multidisciplinary thinking, Munger argues, then one is likely to fall into the trap of:

> "man with a hammer syndrome." And that's taken from the folk saying: To the man with only a hammer, every problem looks pretty much like a nail. And that works marvelously to gum up all professions, and all departments of academia, and indeed most practical life. The only antidote for being an absolute klutz due to the presence of a man with a hammer syndrome is to have a full kit of tools. You don't have just a hammer. You've got all the tools. And you've got to have one more trick. You've got to use those tools checklist-style, because you'll miss a lot if you just hope that the right tool is going to pop up unaided whenever you need it.

Problems to solve

During his speech, to illustrate the types of questions his ways of thinking will help answer, Munger posed a number of problems to solve:

1. There's an activity in America, with one-on-one contests, and a national championship. The same person won the championship on two occasions about 65 years apart. Name the activity.

2. You have studied supply and demand curves. You have learned that when you raise the price, ordinarily the volume you can sell goes down, and when you reduce the price, the volume you can sell goes up. Now tell me several instances when, if you want the physical volume to go up, the correct answer is to increase the price?

3. You own a small casino in Las Vegas. It has 50 standard slot machines. Identical in appearance, they're identical in the function. They have exactly the same payout ratios. The things that cause the payouts are exactly the same. They occur in the same percentages. But there's one machine in this group of slot machines that, no matter where you put it among the 50, in fairly short order, when you go to the machines at the end of the day, there will be 25% more winnings from this one machine than from any other machine. What is different about that heavy-winning machine?

For the answers to these questions, you'll have to read the transcript.

Second- and third-order consequences and free trade
Munger gave a number of examples of how often people only look at immediate consequences of certain actions and fail to consider second- and third-order consequences. For example:

> Everybody in economics understands that comparative advantage is a big deal, when one considers first-order advantages in trade from the Ricardo effect. But suppose you've got a very talented ethnic group, like the Chinese, and they're very poor and backward, and you're an advanced nation, and you create free trade with China, and it goes on for a long time.
>
> Now let's follow and second- and third-order consequences: You are more prosperous than you would have been if you hadn't traded with China in terms of average well-being in the U.S., right? Ricardo proved it. But which nation is going to be growing faster in economic terms? It's obviously China. They're absorbing all the modern technology of the world through this great facilitator in free trade and, like the Asian Tigers have proved, they will get ahead fast. Look at Hong Kong. Look at Taiwan. Look at early Japan. So, you start in a place where you've got a weak nation of backward peasants, a billion and a quarter of them, and in the end they're going to be a much bigger, stronger nation than you are, maybe even having more and better atomic bombs. Well, Ricardo did not prove that that's a wonderful outcome for the former leading nation. He didn't try to determine second-order and higher-order effects.
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> If you try and talk like this to an economics professor, and I've done this three times, they shrink in horror and offense because they don't like this kind of talk. It really gums up this nice discipline of theirs, which is so much simpler when you ignore second- and third-order consequences.

Open-mindedness
How many people do you know who actively seek out opinions contrary to their own? Munger certainly does. For example, he said:

> …take Paul Krugman and read his essays, you will be impressed by his fluency. I can't stand his politics; I'm on the other side. [Krugman constantly bashes Republicans and the Bush administration on the Op Ed page of *The New York Times*.] But I love this man's essays. I think Paul Krugman is one of the best essayists alive.

Destroying your own best-loved ideas
Munger believes that it's absolutely critical not to "cling to failed ideas." You must become good, he argues, "at destroying your own best-loved and hardest-won ideas. If you can get really good at destroying your own wrong ideas, that is a great gift."

How important this is when it comes to investing! Not long ago, I publicly recommended a stock, yet a few weeks later, based on new information, I came to the conclusion that it was no longer a good idea. A natural tendency would have been to hold on to the stock and refuse to admit to my readers that I might have been mistaken. Making it even harder to sell was the fact that the stock had declined - why not wait until it rebounded to the price at which I had bought it, right? (This is a deadly error, as I've discussed in previous columns.) Fortunately, I did sell, refusing to "cling to failed ideas."

Chutzpah
I'll conclude this column with a bit of classic Munger humor: While Buffett bends over backward to appear humble, Munger's the opposite -- he jokes about his big ego. In his opening remarks, he said:

> As I talk about strengths and weaknesses in academic economics, one interesting fact you are entitled to know is that I never took a course in economics. And with this striking lack of credentials, you may wonder why I have the chutzpah to be up here giving this talk. The answer is I have a black belt in chutzpah. I was born with it.

Contributor Whitney Tilson is a longtime guest columnist for The Motley Fool. He owned shares of Berkshire Hathaway at press time, though positions may change at any time. Under no circumstances does this information represent a recommendation to buy, sell, or hold any security. Mr. Tilson appreciates your feedback. To read his previous columns for The Motley Fool and other writings, visit www.tilsonfunds.com. The Motley Fool is investors writing for investors.

The Psychology of Human Misjudgment
by Charles T. Munger

PREFACE

When I read transcripts of my psychology talks given about fifteen years ago, I realized that I could now create a more logical but much longer "talk," including most of what I had earlier said. But I immediately saw four big disadvantages.

First, the longer "talk," because it was written out with more logical completeness, would be more boring and confusing to many people than any earlier talk. This would happen because I would use idiosyncratic definitions of psychological tendencies in a manner reminiscent of both psychology textbooks and Euclid. And who reads textbooks for fun or revisits Euclid?

Second, because my formal psychological knowledge came only from skimming three psychology textbooks about fifteen years ago, I know virtually nothing about any academic psychology later developed. Yet, in a longer talk containing guesses, I would be criticizing much academic psychology. This sort of intrusion into a professional territory by an amateur would be sure to be resented by professors who would rejoice in finding my errors and might be prompted to respond to my published criticism by providing theirs. Why should I care about new criticism? Well, who likes new hostility from articulate critics with an information advantage?

Third, a longer version of my ideas would surely draw some disapproval from people formerly disposed to like me. Not only would there be stylistic and substantive objections, but also there would be perceptions of arrogance in an old man who displayed much disregard for conventional wisdom while "popping-off" on a subject in which he had never taken a course. My old Harvard Law classmate, Ed Rothschild, always called such a popping-off "the shoe button complex," named for the condition of a family friend who spoke in oracular style on all subjects after becoming dominant in the shoe button business.

Fourth, I might make a fool of myself. Despite these four very considerable objections, I decided to publish the much-expanded version. Thus, after many decades in which I have succeeded mostly by restricting action to jobs and methods in which I was unlikely to fail, I have now chosen a course of action in which (1) I have no significant personal benefit to gain, (2) I will surely give some pain to family members and friends, and (3) I may make myself ridiculous. Why am I doing this?

One reason may be that my nature makes me incline toward diagnosing and talking about errors in conventional wisdom. And despite years of being smoothed out by the hard knocks that were inevitable for one with my attitude, I don't believe life ever knocked all the boy's brashness out of the man.

A second reason for my decision is my approval of the attitude of Diogenes when he asked: "Of what use is a philosopher who never offends anybody?"

My third and final reason is the strongest. I have fallen in love with my way of living out psychology because it has been so useful for me. And so, before I die, I want to imitate to some extent the bequest practices of three characters: the protagonist in John Bunyan's Pilgrims Progress, Benjamin Franklin, and my first employer, Ernest Buffett. Bunyan's character, the knight wonderfully named "Old Valiant for Truth," makes the only practical bequest available to him when he says at the end of his life: "My sword I leave to him who can wear it." And like this man, I don't mind if I have misappraised my sword, provided I have tried to see it correctly, or that many will not wish to try it, or that some who try to wield it may find it serves them not. Ben Franklin, to my great benefit, left behind his autobiography, his *Almanacks*, and much else. And Ernest Buffett did the best he could in the same mode when he left behind "How to Run a Grocery Store and a Few Things I Have Learned about Fishing." Whether or not this last contribution to the genre was the best, I will not say. But I will report that I have now known four generations of Ernest Buffett's descendants and that the results have encouraged my imitation of the founder.

I have long been very interested in standard thinking errors. However, I was educated in an era wherein the contributions of non-patient-treating psychology to an understanding of misjudgment met little approval from members of the mainstream elite. Instead, interest in psychology was pretty well confined to a group of professors who talked and published mostly for themselves, with much natural detriment from isolation and groupthink. And so, right after my time at Caltech and Harvard Law School, I possessed a vast ignorance of psychology. Those institutions failed to require knowledge of the subject. And, of course, they couldn't integrate psychology with their other subject matter when they didn't know psychology. Also, like the Nietzsche character who was proud of his lame leg, the institutions were proud of their willful avoidance of "fuzzy" psychology and "fuzzy" psychology professors.

I shared this ignorant mindset for a considerable time. And so did a lot of other people. What are we to think, for instance, of the Caltech course catalogue that for years listed just one psychology professor, self-described as a "Professor of Psychoanalytical Studies," who taught both "Abnormal Psychology" and "Psychoanalysis in Literature"?

Soon after leaving Harvard, I began a long struggle to get rid of the most dysfunctional part of my psychological ignorance. Today, I will describe my long struggle for elementary wisdom and a brief summary of my ending notions. After that, I will give examples, many quite vivid and interesting to me, of both psychology at work and antidotes to psychology-based dysfunction. Then, I will end by asking and answering some general questions

raised by what I have said. This will be a long talk.

When I started law practice, I had respect for the power of genetic evolution and appreciation of man's many evolution-based resemblances to less cognitively-gifted animals and insects. I was aware that man was a "social animal," greatly and automatically influenced by behavior he observed in men around him. I also knew that man lived, like barnyard animals and monkeys, in limited size dominance hierarchies, wherein he tended to respect authority and to like and cooperate with his own hierarchy members while displaying considerable distrust and dislike for competing men not in his own hierarchy.

But this generalized, evolution-based theory structure was inadequate to enable me to cope properly with the cognition I encountered. I was soon surrounded by much extreme irrationality, displayed in patterns and subpatterns. So surrounded, I could see that I was not going to cope as well as I wished with life unless I could acquire a better theory-structure on which to hang my observations and experiences. By then, my craving for more theory had a long history. Partly, I had always loved theory as an aid in puzzle solving and as a means of satisfying my monkey-like curiosity. And, partly. I had found that theory-structure was a superpower in helping one get what one wanted. As I had early discovered in school wherein I had excelled without labor, guided by theory, while many others, without mastery of theory, failed despite monstrous effort. Better theory, I thought. had always worked for me and, if now available, could make me acquire capital and independence faster and better assist everything I loved. And so I slowly developed my own system of psychology. more or less in the self-help style of Ben Franklin and with the determination displayed in the refrain of the nursery story: "'Then I'll do it myself,' said the little red hen."

I was greatly helped in my quest by two turns of mind. First, I had long looked for insight by inversion in the intense manner counseled by the great algebraist, Jacobi: "Invert, always invert." I sought good judgment mostly by collecting instances of bad judgment, then pondering ways to avoid such outcomes. Second, I became so avid a collector of instances of bad judgment that I paid no attention to boundaries between professional territories. After all, why should I search for some tiny, unimportant, hard-to-find new stupidity in my own field when some large, important, easy-to find stupidity was just over the fence in the other fellow's professional territory? Besides, I could already see that real-world problems didn't neatly lie within territorial boundaries. They jumped right across. And I was as dubious of any approach that, when two things were inextricably intertwined and interconnected, would try and think about one thing but not the other. I was afraid, if I tried any such restricted approach, that I would end up, in the immortal words of John L. Lewis, "with no brain at all, just a neck that had haired over."

Pure curiosity, somewhat later, made me wonder how and why destructive cults were often able, over a single long weekend, to turn many tolerably normal people into brainwashed zombies and thereafter keep them in that state indefinitely. I resolved that I would eventually find a good answer to this cult question if I could do so by general reading and much musing.

I also got curious about social insects. It fascinated me that both the fertile female honeybee and the fertile female harvester ant could multiply their quite different normal life expectancies by exactly twenty by engaging in one gangbang in the sky. The extreme success of the ants also fascinated me-how a few behavioral algorithms caused such extreme evolutionary success grounded in extremes of cooperation within the breeding colony and, almost always, extremes of lethal hostility toward ants outside the breeding colony; even ants of the same species.

Motivated as I was, by midlife I should probably have turned to psychology textbooks, but I didn't, displaying my share of the outcome predicted by the German folk saving: "We are too soon old and too late smart." However, as I later found out, I may have been lucky to avoid for so long the academic psychology that was then laid out in most textbooks. These would not then have guided me well with respect to cults and were often written as if the authors were collecting psychology experiments as a boy collects butterflies-with a passion for more butterflies and more contact with fellow collectors and little craving for synthesis in what is already possessed. When I finally got to the psychology texts, I was reminded of the observation of Jacob Viner, the great economist, that many an academic is like the truffle hound, an animal so trained and bred for one narrow purpose that it is no good at anything else. I was also appalled by hundreds of pages of extremely nonscientific musing about comparative weights of nature and nurture in human outcomes. And I found that introductory psychology texts, by and large, didn't deal appropriately with a fundamental issue: Psychological tendencies tend to be both numerous and inseparably intertwined, now and forever, as they interplay in life. Yet the complex parsing out of effects from intertwined tendencies was usually avoided by the writers of the elementary texts. Possibly the authors did not wish, through complexity, to repel entry of new devotees to their discipline. And, possibly, the cause of their inadequacy was the one given by Samuel Johnson in response to a woman who inquired as to what accounted for his dictionary's misdefinition of the word "pastern." "Pure ignorance," Johnson replied. And, finally, the text writers showed little interest in describing standard antidotes to standard psychology-driven folly, and they thus avoided most discussion of exactly what most interested me.

But academic psychology has some very important merits alongside its defects. I learned this eventually, in

the course of general reading, from a book, *Influence,* aimed at a popular audience, by a distinguished psychology professor, Robert Cialdini, at Arizona State, a very big university. Cialdini had made himself into a super-tenured "Regents' Professor" at a very young age by devising, describing, and explaining a vast group of clever experiments in which man manipulated man to his detriment, With all of this made possible by man's intrinsic thinking flaws.

I immediately sent copies of Cialdini's book to all my children. I also gave Cialdini a share of Berkshire stock [Class A] to thank him for what he had done for me and the public. Incidentally, the sale by Cialdini of hundreds of thousands of copies of a book about social psychology was a huge feat, considering that Cialdini didn't claim that he was going to improve your sex life or make you any money.

Part of Cialdini's large book-buying audience came because, like me, it wanted to learn how to become less often tricked by salesmen and circumstances. However, as an outcome not sought by Cialdini, who is a profoundly ethical man, a huge number of his books were bought by salesmen who wanted to learn how to become more effective in misleading customers. Please remember this perverse outcome when my discussion comes to incentive-caused bias as a consequence of the superpower of incentives.

With the push given by Cialdini's book, I soon skimmed through three much used textbooks covering introductory psychology. I also pondered considerably while craving synthesis and taking into account all my previous training and experience. The result was Munger's partial summary of the non-patient-treating, non-nature vs. nurture weighing parts of nondevelopmental psychology. This material was stolen from its various discoverers (most of whose names I did not even try to learn), often with new descriptions and titles selected to fit Munger's notion of what makes recall easy for Munger, then revised to make Munger's use easy as he seeks to avoid errors.

I will start my summary with a general observation that helps explain what follows. This observation is grounded in what we know about social insects. The limitations inherent in evolution's development of the nervous-system cells that control behavior are beautifully demonstrated by these insects, which often have a mere 100,000 or so cells in their entire nervous systems, compared to man's multiple billions of cells in his brain alone.

Each ant, like each human, is composed of a living physical structure plus behavioral algorithms in its nerve cells. In the ant's case, the behavioral algorithms are few in number and almost entirely genetic in origin. The ant learns a little behavior from experiences, but mostly it merely responds to ten or so stimuli with a few simple responses programmed into its nervous system by its genes, sometimes walk round and round until they perish.

It seems obvious, to me at least, that the human brain must often operate counterproductively just like the ant's, from unavoidable oversimplicity in its mental process, albeit usually in trying to solve problems more difficult than those faced by ants that don't have to design airplanes.

Naturally, the simple ant behavior system has extreme limitations because of its limited nerve system repertoire. For instance, one type of ant, when it smells a pheromone given off by a dead ant's body in the hive, immediately responds by cooperating with other ants in carrying the dead body out of the hive. And Harvard's great E.O. Wilson performed one of the best psychology experiments ever done when he painted dead-ant pheromone on a live ant. Quite naturally; the other ants dragged this useful live ant out of the hive even though it kicked and otherwise protested throughout the entire process. Such is the brain of the ant. It has a simple program of responses that generally work out all right, but which are imprudently used by rote in many cases.

Another type of ant demonstrates that the limited brain of ants can be misled by circumstances as well as by clever manipulation from other creatures. The brain of this ant contains a simple behavioral program that directs the ant, when walking, to follow the ant ahead, and when these ants stumble into walking in a big circle. The perception system of man clearly demonstrates just such an unfortunate outcome. Man is easily fooled, either by the cleverly thought out manipulation of man, by circumstances occurring by accident, or by very effective manipulation practices that man has stumbled into during "practice evolution" and kept in place because they work so well. One such outcome is caused by a quantum effect in human perception. If stimulus is kept below a certain level, it does not get through. And, for this reason, a magician was able to make the Statue of Liberty disappear after a certain amount of magician lingo expressed in the dark. The audience was not aware that it was sitting on a platform that was rotating so slowly, below man's sensory threshold, that no one could feel the acceleration implicit in the considerable rotation. When a surrounding curtain was then opened in the place on the platform where the Statue had earlier appeared, it seemed to have disappeared.

And even when perception does get through to man's brain, it is often misweighted, because what is registered in perception is in shockingness of apparent contrast, not the standard scientific units that make possible science and good engineering against often-wrong effects from generally useful tendencies in his perception and cognition.

A magician demonstrates this sort of contrast based error in your nervous system when he removes your wristwatch without your feeling it. As he does this, he applies pressure of touch on your wrist that you would

sense if it was the only pressure of touch you were experiencing. But he has concurrently applied other intense pressure of touch on your body, but not on your wrist, "swamping" the wrist pressure by creating a high-contrast touch pressure elsewhere. This high contrast takes the wrist pressure below perception.

Some psychology professors like to demonstrate the inadequacy of contrast-based perception by having students put one hand in a bucket of hot water and one hand in a bucket of cold water. They are then suddenly asked to remove both hands and place them in a single bucket of room temperature water. Now, with both hands in the same water, one hand feels as if it has just been put in cold water and the other hand feels as if it has just been placed in hot water. When one thus sees perception so easily fooled by mere contrast, where a simple temperature gauge would make no error, and realizes that cognition mimics perception in being misled by mere contrast, he is well on the way toward understanding, not only how magicians fool one, but also how life will fool one. This can occur, through deliberate human manipulation or otherwise, if one doesn't take certain precautions.

Man's often wrong but generally useful psychological tendencies are quite numerous and quite different. The natural consequence of this profusion of tendencies is the grand general principle of social psychology: cognition is ordinarily situation-dependent so that different situations often cause different conclusions, even when the same person is thinking in the same general subject area. With this introductory instruction from ants, magicians, and the grand general principle of social psychology; I will next simply number and list psychology-based tendencies that, while generally useful, often mislead. Discussion of errors from each tendency will come later, together with description of some antidotes to errors, followed by some general discussion. Here are the tendencies:

1. Reward and Punishment Superresponse Tendency
2. Liking/Loving Tendency
3. Disliking/Hating Tendency
4. Doubt-Avoidance Tendency
5. Inconsistency-Avoidance Tendency
6. Curiosity Tendency
7. Kantian Fairness Tendency
8. Envy/Jealousy Tendency
9. Reciprocation Tendency
10. Influence-from-Mere Association Tendency
11. Simple, Pain-Avoiding Psychological Denial
12. Excessive Self-Regard Tendency
13. Overoptimism Tendency
14. Deprival Superreaction Tendency
15. Social-Proof Tendency
16. Contrast-Misreaction Tendency
17. Stress-Influence Tendency
18. Availability-Misweighing Tendency
19. Use-It-or-Lose-It Tendency
20. Drug-Misinfluence Tendency
21. Senescence-Misinfluence Tendency
22. Authority-Misinfluence Tendency
23. Twaddle Tendency
24. Reason-Respecting Tendency
25. Lollapalooza Tendency – The Tendency to Get Extreme Confluences of Psychological Tendencies Acting in Favor of a Particular Outcome

1. Reward and Punishment Superresponse Tendency

I place this tendency first in my discussion because almost everyone thinks he fully recognizes how important incentives and disincentives are in changing cognition and behavior. But this is not often so. For instance, I think I've been in the top five percent of my age cohort almost all my adult life in understanding the power of incentives, and yet I've always underestimated that power. Never a year passes but I get some surprise that pushes a little further my appreciation of incentive superpower.

One of my favorite cases about the power of incentives is the Federal Express case. The integrity of the Federal Express system requires that all packages be shifted rapidly among airplanes in one central airport each night. And the system has no integrity for the customers if the night work shift can't accomplish its assignment fast. And Federal Express had one hell of a time getting the night shift to do the right thing. They tried moral suasion. They tried everything in the world without luck. And, finally, somebody got the happy thought that it was foolish to pay the night shift by the hour when what the employer wanted was not maximized billable hours of employee service but fault-free, rapid performance of a particular task. Maybe, this person thought, if they paid the employees per shift and let all night shift employees go home when all the planes were loaded, the system would work better. And, lo and behold, that solution worked.

Early in the history of Xerox, Joe Wilson, who was then in the government, had a similar experience. He had to go back to Xerox because he couldn't understand why its new machine was selling so poorly in relation to its older and inferior machine. When he got back to Xerox, he found out that the commission arrangement with the salesmen gave a large and perverse incentive to push the inferior machine on customers, who deserved a better result.

And then there is the case of Mark Twain's cat that, after a bad experience with a hot stove, never again sat on a hot stove, or a cold stove either.

We should also heed the general lesson implicit in the injunction of Ben Franklin in *Poor Richard's Almanack*: "If you would persuade, appeal to interest and not to reason." This maxim is a wise guide to a great and simple precaution in life: Never, ever, think about something else when you should be thinking about the power of incentives. I once saw a very smart house counsel for a major investment bank lose his job, with no moral fault, because he ignored the lesson in this maxim of Franklin. This counsel failed to persuade his client because he told him his moral duty, as correctly conceived by the counsel, without also telling the client in vivid terms that he was very likely to be clobbered to smithereens if he didn't behave as his counsel recommended. As a result, both client and counsel lost their careers.

We should also remember how a foolish and willful ignorance of the superpower of rewards caused Soviet communists to get their final result as described by one employee: "They pretend to pay us and we pretend to work." Perhaps the most important rule in management is "Get the incentives right."

But there is some limit to a desirable emphasis on incentive superpower. One case of excess emphasis happened at Harvard, where B. F. Skinner, a psychology professor, finally made himself ridiculous. At one time, Skinner may have been the best-known psychology professor in the world. He partly deserved his peak reputation because his early experiments using rats and pigeons were ingenious, and his results were both counterintuitive and important. With incentives, he could cause more behavior change, culminating in conditioned reflexes in his rats and pigeons, than he could in any other way. He made obvious the extreme stupidity, in dealing with children or employees, of rewarding behavior one didn't want more of. Using food rewards, he even caused strong superstitions, predesigned by himself, in his pigeons. He demonstrated again and again a great recurring, generalized behavioral algorithm in nature: "Repeat behavior that works." He also demonstrated that prompt rewards worked much better than delayed rewards in changing and maintaining behavior. And, once his rats and pigeons had conditioned reflexes, caused by food rewards, he found what withdrawal pattern of rewards kept the reflexive behavior longest in place: random distribution. With this result, Skinner thought he had pretty well explained man's misgambling compulsion whereunder he often foolishly proceeds to ruin. But, as we shall later see when we discuss other psychological tendencies that contribute to misgambling compulsion, he was only partly right. Later, Skinner lost most of his personal reputation by overclaiming for incentive superpower to the point of thinking he could create a human utopia with it and by displaying hardly any recognition of the power of the rest of psychology. He thus behaved like one of Jacob Viner's truffle hounds as he tried to explain everything with incentive effects. Nonetheless, Skinner was right in his main idea: Incentives are superpowers. The outcome of his basic experiments will always remain in high repute in the annals of experimental science. And his method of monomaniacal reliance on rewards, for many decades after his death, did more good than anything else in improving autistic children.

When I was at Harvard Law School, the professors sometimes talked about an overfocused, Skinner-like professor at Yale Law School. They used to say: "Poor old Eddie Blanchard, he thinks declaratory judgments will cure cancer." Well, that's the way Skinner got with his very extreme emphasis on incentive superpower. I always call the "Johnny-one-note" turn of mind that eventually diminished Skinner's reputation the man-with-a-hammer tendency, after the folk saying: "To a

man with only a hammer every problem looks pretty much like a nail." Man-with-a-hammer tendency does not exempt smart people like Blanchard and Skinner. And it won't exempt you if you don't watch out. I will return to man-with-a-hammer tendency at various times in this talk because, fortunately, there are effective antidotes that reduce the ravages of what pretty much ruined the personal reputation of the brilliant Skinner.

One of the most important consequences of incentive superpower is what I call "incentive caused bias." A man has an acculturated nature making him a pretty decent fellow, and yet, driven both consciously and subconsciously by incentives, he drifts into immoral behavior in order to get what he wants, a result he facilitates by rationalizing his bad behavior, like the salesmen at Xerox who harmed customers in order to maximize their sales commissions.

Here, my early education involved a surgeon who over the years sent bushel baskets full of normal gall bladders down to the pathology lab in the leading hospital in Lincoln, Nebraska, my grandfather's town. And, with that permissive quality control for which community hospitals are famous, many years after this surgeon should've been removed from the medical staff, he was. One of the doctors who participated in the removal was a family friend, and I asked him: "Did this surgeon think, 'Here's a way for me to exercise my talents'" – this guy was very skilled technically – "'and make a high living by doing a few maimings and murders every year in the course of routine fraud?'" And my friend answered: "Hell no, Charlie. He thought that the gall bladder was the source of all medical evil, and, if you really loved your patients, you couldn't get that organ out rapidly enough."

Now that's an extreme case, but in lesser strength, the cognitive drift of that surgeon is present in every profession and in every human being. And it causes perfectly terrible behavior. Consider the presentations of brokers selling commercial real estate and businesses. I've never seen one that I thought was even within hailing distance of objective truth. In my long life, I have never seen a management consultant's report that didn't end with the same advice: "This problem needs more management consulting services." Widespread incentive-caused bias requires that one should often distrust, or take with a grain of salt, the advice of one's professional advisor, even if he is an engineer. The general **antidotes** here are:

1) especially fear professional advice when it is especially good for the advisor;
2) learn and use the basic elements of your advisor's trade as you deal with your advisor; and
3) double check, disbelieve, or replace much of what you're told, to the degree that seems appropriate after objective thought.

The power of incentives to cause rationalized, terrible behavior is also demonstrated by Defense Department procurement history. After the Defense Department had much truly awful experience with misbehaving contractors motivated under contracts paying on a cost-plus-a-percentage-of cost basis, the reaction of our republic was to make it a crime for a contracting officer in the Defense Department to sign such a contract, and not only a crime, but a felony.

And, by the way, although the government was right to create this new felony, much of the way the rest of the world is run, including the operation of many law firms and a lot of other firms, is still under what is, in essence, a cost-plus-a-percentage-of-cost reward system. And human nature, bedeviled by incentive-caused bias, causes a lot of ghastly abuse under these standard incentive patterns of the world. And many of the people who are behaving terribly you would be glad to have married into your family, compared to what you're otherwise likely to get.

Now there are huge implications from the fact that the human mind is put together this way. One implication is that people who create things like cash registers, which make dishonest behavior hard to accomplish, are some of the effective saints of our civilization because, as Skinner so well knew, bad behavior is intensely habit-forming when it is rewarded.

And so the cash register was a great moral instrument when it was created. And, by the way, Patterson, the great evangelist of the cash register, knew that from his own experience. He had a little store, and his employees were stealing him blind, so that he never made any money. Then people sold him a couple of cash registers, and his store went to profit immediately. He promptly closed the store and went into the cash register business, creating what became the mighty National Cash Register Company, one of the glories of its time. "Repeat behavior that works" is a behavioral guide that really succeeded for Patterson, after he applied one added twist. And so did high moral cognition. An eccentric, inveterate do-gooder (except when destroying competitors, all of which he regarded as would-be patent thieves), Patterson, like Carnegie, pretty well gave away all his money to charity before he died, always pointing out that "shrouds have no pockets." So great was the contribution of Patterson's cash register to civilization, and so effectively did he improve the cash register and spread its use, that in the end, he probably deserved the epitaph chosen for the Roman poet Horace: "I did not completely die."

The strong tendency of employees to rationalize bad conduct in order to get rewards requires many antidotes in addition to the good cash control promoted by Patterson. Perhaps the most important of these antidotes is use of sound accounting theory and practice. This was seldom better demonstrated than at Westinghouse, which had a subsidiary that made loans having no connection to the rest of Westinghouse's businesses. The officers of Westinghouse, perhaps influenced by

envy of General Electric, wanted to expand profits from loans to outsiders. Under Westinghouse's accounting practice, provisions for future credit losses on these loans depended largely on the past credit experience of its lending subsidiary, which mainly made loans unlikely to cause massive losses.

Now there are two special classes of loans that naturally cause much trouble for lenders. The first is ninety-five percent-of-value construction loans to any kind of real estate developer, and the second is any kind of construction loan on a hotel. So, naturally, if one were willing to loan approximately ninety-five percent of the real cost to a developer constructing a hotel, the loan would bear a much higher-than-normal interest rate because the credit loss danger would be much higher than normal. So, sound accounting for Westinghouse in making a big, new mass of ninety-five percent-of-value construction loans to hotel developers would have been to report almost no profit, or even a loss, on each loan until, years later, the loan became clearly worth par. But Westinghouse instead plunged into big-time construction lending on hotels, using accounting that made its lending officers look good because it showed extremely high starting income from loans that were very inferior to the loans from which the company had suffered small credit losses in the past. This terrible accounting was allowed by both international and outside accountants for Westinghouse as they displayed the conduct predicted by the refrain: "Whose bread I eat, his song I sing."

The result was billions of dollars of losses. Who was at fault? The guy from the refrigerator division, or some similar division, who as lending officer was suddenly in charge of loans to hotel developers: Or the accountants and other senior people who tolerated a nearly insane incentive structure, almost sure to trigger incentive-caused bias in a lending officer: My answer puts most blame on the accountants and other senior people who created the accounting system. These people became the equivalent of an armored car cash carrying service that suddenly decided to dispense with vehicles and have unarmed midgets hand-carry its customers' cash through slums in open bushel baskets.

I wish I could tell you that this sort of thing no longer happens, but this is not so. After Westinghouse blew up, General Electric's Kidder Peabody subsidiary put a silly computer program in place that allowed a bond trader to show immense fictional profits. And after that, much accounting became even worse, perhaps reaching its nadir at Enron.

So incentive-caused bias is a huge, important thing, with highly important **antidotes**, like the cash register and a sound accounting system. But when I came years ago to the psychology texts, I found that, while they were about one thousand pages long, there was as little therein that dealt with incentive-caused bias and no mention of Patterson or sound accounting systems. Somehow incentive-caused bias and its antidotes pretty well escaped the standard survey courses in psychology, even though incentive-caused bias had long been displayed prominently in much of the world's great literature, and antidotes to it had long existed in standard business routines. In the end, I concluded that when something was obvious in life but not easily demonstrable in certain kinds of easy, repeatable academic experiments, the truffle hounds of psychology very often missed it.

In some cases, other disciplines showed more interest in psychological tendencies than did psychology, at least as explicated in psychology textbooks. For instance, economists, speaking from the employer's point of view, have long had a name for the natural results of incentive-caused bias: "agency cost." As the name implies, the economists have typically known that, just as grain is always lost to rats, employers always lose to employees who improperly think of themselves first. Employer installed **antidotes** include:

1) tough internal audit systems,
2) severe public punishment for identified miscreants, as well as
3) misbehavior-preventing routines and such machines as cash registers.

From the employee's point of view, incentive-caused bias quite naturally causes opposing abuse from the employer: the sweatshop, the unsafe work place, etc. And these bad results for employees have **antidotes** not only in

1) pressure from unions, but also in
2) government action, such as wage and hour laws, workplace safety rules, measures fostering unionization, and workers' compensation systems.

Given the opposing psychology-induced strains that naturally occur in employment because of incentive-caused bias on both sides of the relationship, it is no wonder the Chinese are so much into Yin and Yang.

The inevitable ubiquity of incentive-caused bias has vast, generalized consequences. For instance, a sales force living only on commissions will be much harder to keep moral than one under less pressure from the compensation arrangement. On the other hand, a purely commissioned sales force may well be more efficient per dollar spent. Therefore, difficult decisions involving trade-offs are common in creating compensation arrangements in the sales function.

The extreme success of free-market capitalism as an economic system owes much to its prevention of many of bad effects from incentive-caused bias. Most capitalist owners in a vast web of free market economic activity are selected for ability by surviving in a brutal competition with other owners and have a strong incentive to prevent all waste in operations within their ownership. After all, they live on the difference between their competitive prices and their overall costs and their businesses will perish if costs exceed sales. Replace such

owners by salaried employees of the state and you will normally get a substantial reduction in overall efficiency as each employee who replaces an owner is subject to incentive-caused bias as he determines what service he will give in exchange for his salary and how much he will yield to peer pressure from many fellow employees who do not desire his creation of any strong performance model.

Another generalized consequence of incentive caused bias is that man tends to "game" all human systems, often displaying great ingenuity in wrongly serving himself at the expense of others. Antigaming features, therefore, constitute a huge and necessary part of almost all system design. Also needed in system design is an admonition: dread, and avoid as much you can, rewarding people for what can be easily faked. Yet our legislators and judges, usually including many lawyers educated in eminent universities, often ignore this injunction. And society consequently pays a huge price in the deterioration of behavior and efficiency, as well as the incurrence of unfair costs and wealth transfers. If education were improved, with psychological reality becoming better taught and assimilated, better system design might well come out of our legislatures and courts.

Of course, money is now the main reward that drives habits. A monkey can be trained to seek and work for an intrinsically worthless token, as if it were a banana, if the token is routinely exchangeable for a banana. So it is also with humans working for money – only more so, because human money is exchangeable for many desired things in addition to food, and one ordinarily gains status from either holding or spending it. Moreover, a rich person will often, through habit, work or connive energetically for more money long after he has almost no real need for more. Averaged out, money is a mainspring of modern civilization, having little precedent in the behavior of nonhuman animals. Money rewards are also intertwined with other forms of reward. For instance, some people use money to buy status and others use status to get money, while still others sort of do both things at the same time.

Although money is the main driver among rewards, it is not the only reward that works. People also change their behavior and cognition for sex, friendship, companionship, advancement in status, and other nonmonetary items.

"Granny's Rule" provides another example of reward superpower, so extreme in its effects that it must be mentioned here. You can successfully manipulate your own behavior with this rule, even if you are using as rewards items that you already possess! Indeed, consultant Ph.D. psychologists often urge business organizations to improve their reward systems by teaching executives to use "Granny's Rule" to govern their own daily behavior. Granny's Rule, to be specific, is the requirement that children eat their carrots before they get dessert. And the business version requires that executives force themselves daily to first do their unpleasant and necessary tasks before rewarding themselves by proceeding to their pleasant tasks. Given reward superpower, this practice is nice and sound. Moreover, the rule can also be used in the nonbusiness part of life. The emphasis on daily use of this practice is not accidental. The consultants well know, after the teaching of Skinner, that prompt rewards work best.

Punishments, of course, also strongly influence behavior and cognition, although not so flexibly and wonderfully as rewards. For instance, illegal price fixing was fairly common in America when it was customarily punished by modest fines. Then, after a few prominent business executives were removed from their eminent positions and sent to federal prisons, price-fixing behavior was greatly reduced.

Military and naval organizations have very often been extreme in using punishment to change behavior, probably because they needed to cause extreme behavior. Around the time of Caesar, there was a European tribe that, when the assembly horn blew, always killed the last warrior to reach his assigned place, and no one enjoyed fighting this tribe. And George Washington hanged farm-boy deserters forty feet high as an example to others who might contemplate desertion.

2. Liking/Loving Tendency

A newly hatched baby goose is programmed, through the economy of its genetic program, to "love" and follow the first creature that is nice to it, which is almost always its mother. But, if the mother goose is not present right after the hatching, and a man is there instead, the gosling will "love" and follow the man, who becomes a sort of substitute mother.

Somewhat similarly, a newly arrived human is "born to like and love" under the normal and abnormal triggering outcomes for its kind. Perhaps the strongest inborn tendency to love – ready to be triggered – is that of the human mother for its child. On the other hand, the similar "child-loving" behavior of a mouse can be eliminated by the deletion of a single gene, which suggests there is some sort of triggering gene in a mother mouse as well as in a gosling.

Each child, like a gosling, will almost surely come to like and love, not only as driven by its sexual nature, but also in social groups not limited to its genetic or adoptive "family." Current extremes of romantic love almost surely did not occur in man's remote past. Our early human ancestors were surely more like apes triggered into mating in a pretty mundane fashion.

And what will a man naturally come to like and love, apart from his parent, spouse and child? Well, he will like and love being liked and loved. And so many a courtship competition will be won by a person displaying exceptional devotion, and man will generally strive, lifelong, for the affection and approval of many people not related to him.

One very practical consequence of Liking/Loving Tendency is that it acts as a conditioning device that makes the liker or lover tend:

1) to ignore faults of, and comply with wishes of, the object of his affection,
2) to favor people, products, and actions merely associated with the object of his affection (as we shall see when we get to "Influence-from-Mere-Association Tendency," and
3) to distort other facts to facilitate love.

There are large social policy implications in the amazingly good consequences that ordinarily come from people likely to trigger extremes of love and admiration boosting each other in a feedback mode. For instance, it is obviously desirable to attract a lot of lovable, admirable people into the teaching profession. The phenomenon of liking and loving causing admiration also works in reverse. Admiration also causes or intensifies liking or love. With this "feedback mode" in place, the consequences are often extreme, sometimes even causing deliberate self-destruction to help what is loved.

Liking or loving, intertwined with admiration in a feedback mode, often has vast practical consequences in areas far removed from sexual attachments. For instance, a man who is so constructed that he loves admirable persons and ideas with a special intensity has a huge advantage in life. This blessing came to both Buffett and myself in large measure, sometimes from the same persons and ideas. One common, beneficial example for us both was Warren's uncle, Fred Buffett, who cheerfully did the endless grocery-store work that Warren and I ended up admiring from a safe distance. Even now, after I have known so many other people, I doubt if it is possible to be a nicer man than Fred Buffett was, and he changed me for the better.

3. Disliking/Hating Tendency

In a pattern obverse to Liking/Loving Tendency, the newly arrived human is also "born to dislike and hate" as triggered by normal and abnormal triggering forces in its life. It is the same with most apes and monkeys.

As a result, the long history of man contains almost continuous war. For instance, most American Indian tribes warred incessantly, and some tribes would occasionally bring captives home to women so that all could join in the fun of torturing captives to death. Even with the spread of religion, and the advent of advanced civilization, much modern war remains pretty savage. But we also get what we observe in present-day Switzerland and the United States, wherein the clever political arrangements of man "channel" the hatreds and dislikings of individuals and groups into nonlethal patterns including elections.

But the dislikings and hatreds never go away completely. Born into man, these driving tendencies remain strong. Thus, we get maxims like the one from England: "Politics is the art of marshalling hatreds." And we also get the extreme popularity of very negative political advertising in the United States.

At the family level, we often see one sibling hate his other siblings and litigate with them endlessly if he can afford it. Indeed, Warren Buffett has repeatedly explained to me that "a major difference between rich and poor people is that the rich people can spend their lives suing their relatives." My father's law practice in Omaha was full of such intrafamily hatreds. And when I got to the Harvard Law School and its professors taught me "property law" with no mention of sibling rivalry in the family business, I appraised the School as a pretty unrealistic place that wore "blinders" like the milk-wagon horses of yore. My current guess is that sibling rivalry has not yet made it into property law as taught at Harvard.

Disliking/Hating Tendency also acts as a conditioning device that makes the disliker/hater tend to:

1) ignore virtues in the object of dislike,
2) dislike people, products, and actions merely associated with the object of his dislike, and
3) distort other facts to facilitate hatred.

Distortion of that kind is often so extreme that miscognition is shockingly large. When the world Trade Center was destroyed, many Muslims immediately concluded that the Hindus did it, while many Arabs concluded that the Jews did it. Such factual distortions often make mediation between opponents locked in hatred either difficult or impossible. Mediations between Israelis and Palestinians are difficult because facts in one side's history overlap very little with facts from the other side's.

4. Doubt-Avoidance Tendency

The brain of man is programmed with a tendency to quickly remove doubt by reaching some decision. It is easy to see how evolution would make animals, over the eons, drift toward such quick elimination of doubt. After all, the one thing that is surely counterproductive for a prey animal that is threatened by a predator is to take a long time in deciding what to do. And so man's Doubt Avoidance Tendency is quite consistent with the history of his ancient, nonhuman ancestors.

So pronounced is the tendency in man to quickly remove doubt by reaching some decision that behavior to counter the tendency is required from judges and jurors. Here, delay before decision making is forced. And one is required to so comport himself, prior to conclusion time, so that he is wearing a "mask" of objectivity. And the "mask" works to help real objectivity along, as we shall see when we next consider man's Inconsistency-Avoidance Tendency.

Of course, once one has recognized that man has a strong Doubt-Avoidance Tendency, it is logical to believe that at least some leaps of religious faith are greatly boosted by this tendency. Even if one is satisfied that his own faith comes from revelation, one still must account for the inconsistent faiths of others. And man's Doubt-

Avoidance Tendency is almost surely a big part of the answer.

What triggers Doubt-Avoidance Tendency? Well, an unthreatened man, thinking of nothing in particular, is not being prompted to remove doubt through rushing to some decision. As we shall see later when we get to Social-Proof Tendency and Stress-Influence Tendency, what usually triggers Doubt-Avoidance Tendency is some combination of puzzlement and stress. Both of these factors naturally occur in facing religious issues. Thus, the natural state of most men is in some form of doubt-removing religious faith.

5. Inconsistency-Avoidance Tendency

The brain of man conserves programming space by being reluctant to change, which is a form of inconsistency avoidance. We see this in all human habits, constructive and destructive. Few people can list a lot of bad habits that they have eliminated, and some people cannot identify even one of these. Instead, practically everyone has a great many bad habits he has long maintained despite their being known as bad. Given this situation, it is not too much in many cases to appraise early-formed habits as destiny. When Marley's miserable ghost says, "I wear the chains I forged in life," he is talking about chains of habit that were too light to be felt before they became too strong to be broken.

The rare life that is wisely lived has in it many good habits maintained and many bad habits avoided or cured. And the great rule that helps here is again from Franklin's *Poor Richard's Almanack:* "An ounce of prevention is worth a pound of cure." What Franklin is here indicating, in part, is that Inconsistency-Avoidance Tendency makes it much easier to prevent a habit than to change it.

Also tending to be maintained in place by the anti-change tendency of the brain are one's previous conclusions, human loyalties, reputational identity, commitments, accepted role in a civilization, etc. It is not entirely clear why evolution would program into man's brain an anti-change mode alongside his tendency to quickly remove doubt. My guess is the anti-change mode was significantly caused by a combination of the following factors:

1) It facilitated faster decisions when speed of decision was an important contribution to the survival of nonhuman ancestors that were prey.
2) It facilitated the survival advantage that our ancestors gained by cooperating in groups, which would have been more difficult to do if everyone was always changing responses.
3) It was the best form of solution that evolution could get to in the limited number of generations between the start of literacy and today's complex modern life.

It is easy to see that a quickly reached conclusion, triggered by Doubt-Avoidance Tendency, when combined with a tendency to resist any change in that conclusion, will naturally cause a lot of errors in cognition for modern man. And so it observably works out. We all deal much with others whom we correctly diagnose as imprisoned in poor conclusions that are maintained by mental habits they formed early and will carry to their graves.

So great is the bad-decision problem caused by Inconsistency-Avoidance Tendency that our courts have adopted important strategies against it. For instance, before making decisions, judges and juries are required to hear long and skillful presentations of evidence and argument from the side they will not naturally favor, given their ideas in place. And this helps prevent considerable bad thinking from "first conclusion bias." Similarly, other modern decision makers will often force groups to consider skillful counterarguments before making decisions.

And proper education is one long exercise in augmentation of high cognition so that our wisdom becomes strong enough to destroy wrong thinking, maintained by resistance to change. As Lord Keynes pointed out about his exalted intellectual group at one of the greatest universities in the world, it was not the intrinsic difficulty of new ideas that prevented their acceptance. Instead, the new ideas were not accepted because they were inconsistent with old ideas in place. What Keynes was reporting is that the human mind works a lot like the human egg. When one sperm gets into a human egg, there's an automatic shut-off device that bars any other sperm from getting in. The human mind tends strongly toward the same sort of result.

And so, people tend to accumulate large mental holdings of fixed conclusions and attitudes that are not often reexamined or changed, even though there is plenty of good evidence that they are wrong.

Moreover, this doesn't just happen in social science departments, like the one that once thought Freud should serve as the only choice as a psychology teacher for Caltech. Holding to old errors even happens, although with less frequency and severity, in hard science departments. We have no less an authority for this than Max Planck, Nobel laureate, finder of "Planck's constant." Planck is famous not only for his science but also for saying that even in physics the radically new ideas are seldom really accepted by the old guard. Instead, said Planck, the progress is made by a new generation that comes along, less brain-blocked by its previous conclusions. Indeed, precisely this sort of brain-blocking happened to a degree in Einstein. At his peak, Einstein was a great destroyer of his own ideas, but an older Einstein never accepted the full implications of quantum mechanics.

One of the most successful users of an antidote to first conclusion bias was Charles Darwin. He trained himself, early, to intensively consider any evidence tending to disconfirm any hypothesis of his, more so if he

thought his hypothesis was a particularly good one. The opposite of what Darwin did is now called confirmation bias, a term of opprobrium. Darwin's practice came from his acute recognition of man's natural cognitive faults arising from Inconsistency-Avoidance Tendency. He provides a great example of psychological insight correctly used to advance some of the finest mental work ever done.

Inconsistency-Avoidance Tendency has many good effects in civilization. For instance, rather than act inconsistently with public commitments, new or old public identities, etc., most people are more loyal in their roles in life as priests, physicians, citizens, soldiers, spouses, teachers, employees, etc.

One corollary of Inconsistency-Avoidance Tendency is that a person making big sacrifices in the course of assuming a new identity will intensify his devotion to the new identity. After all, it would be quite inconsistent behavior to make a large sacrifice for something that was no good. And thus civilization has invented many tough and solemn initiation ceremonies, often public in nature, that intensify new commitments made.

Tough initiation ceremonies can intensify bad contact as well as good. The loyalty of the new, "made-man" mafia member, or of the military officer making the required "blood oath" of loyalty to Hitler, was boosted through the triggering of Inconsistency-Avoidance Tendency.

Moreover, the tendency will often make man a "patsy" of manipulative "compliance-practitioners," who gain advantage from triggering his subconscious Inconsistency-Avoidance Tendency. Few people demonstrated this process better than Ben Franklin. As he was rising from obscurity in Philadelphia and wanted the approval of some important man, Franklin would often maneuver that man into doing Franklin some unimportant favor, like lending Franklin a book. Thereafter, the man would admire and trust Franklin more because a nonadmired and nontrusted Franklin would be inconsistent with the appraisal implicit in lending Franklin the book.

During the Korean War, this technique of Franklin's was the most important feature of the Chinese brainwashing system that was used on enemy prisoners. Small step by small step, the technique often worked better than torture in altering prisoner cognition in favor of Chinese captors.

The practice of Franklin, whereunder he got approval from someone by maneuvering him into treating Franklin favorably, works viciously well in reverse. When one is maneuvered into deliberately hurting some other person, one will tend to disapprove or even hate that person. This effect, from Inconsistency-Avoidance Tendency, accounts for the insight implicit in the saying: "A man never forgets where he has buried the hatchet." The effect accounts for much prisoner abuse by guards, increasing their dislike and hatred for prisoners that exists as a consequence of the guards' reciprocation of hostility from prisoners who are treated like animals. Given the psychology-based hostility natural in prisons between guards and prisoners, an intense, continuous effort should be made to prevent prisoner abuse from starting and to stop it instantly when it starts because it will grow by feeding on itself, like a cluster of infectious disease. More psychological acuity on this subject, aided by more insightful teaching, would probably improve the overall effectiveness of the U.S. Army.

So strong is Inconsistency-Avoidance Tendency that it will often prevail after one has merely pretended to have some identity, habit, or conclusion. Thus, for a while, many an actor sort of believes he is Hamlet, Prince of Denmark. And many a hypocrite is improved by his pretensions of virtue. And many a judge and juror, while pretending objectivity, is gaining objectivity. And many a trial lawyer or other advocate comes to believe what he formerly only pretended to believe.

While Inconsistency-Avoidance Tendency, with its "status quo bias," immensely harms sound education, it also causes much benefit. For instance, a near-ultimate inconsistency would be to teach something to others that one did not believe true. And so, in clinical medical education, the learner is forced to "see one, do one, and then teach one," with the teaching pounding the learning into the teacher. Of course, the power of teaching to influence the cognition of the teacher is not always a benefit to society. When such power flows into political and cult evangelism, there are often bad consequences.

For instance, modern education often does much damage when young students are taught dubious political notions and then enthusiastically push these notions on the rest of us. The pushing seldom convinces others. But as students pound into their mental habits what they are pushing out, the students are often permanently damaged. Educational institutions that create a climate where much of this goes on are, I think, irresponsible. It is important not to thus put one's brain in chains before one has come anywhere near his full potentiality as a rational person.

6. Curiosity Tendency

There is a lot of innate curiosity in mammals, but its nonhuman version is highest among apes and monkeys. Man's curiosity, in turn, is much stronger than that of his simian relatives. In advanced human civilization, culture greatly increases the effectiveness of curiosity in advancing knowledge. For instance, Athens (including its colony, Alexandria) developed much math and science out of pure curiosity while the Romans made almost no contribution to either math or science. They instead concentrated their attention on the "practical" engineering of mines, roads, aqueducts, etc. Curiosity, enhanced by the best of modern education (which is by definition a minority part in many places), much helps man to prevent or reduce bad consequences arising

from other psychological tendencies. The curious are also provided with much fun and wisdom long after formal education has ended.

7. Kantian Fairness Tendency

Kant was famous for his "categorical imperative," a sort of a "golden rule" that required humans to follow those behavior patterns that, if followed by all others, would make the surrounding human system work best for everybody. And it is not too much to say that modern acculturated man displays, and expects from others, a lot of fairness as thus defined by Kant.

In a small community having a one-way bridge or tunnel for autos, it is the norm in the United States to see a lot of reciprocal courtesy, despite the absence of signs or signals. And many freeway drivers, including myself, will often let other drivers come in front of them, in lane changes or the like, because that is the courtesy they desire when roles are reversed. Moreover, there is, in modern human culture, a lot of courteous lining up by strangers so that all are served on a "first-come-first-served" basis.

Also, strangers often voluntarily share equally in unexpected, unearned good and bad fortune. And, as an obverse consequence of such "fair-sharing" conduct, much reactive hostility occurs when fairsharing is expected yet not provided.

It is interesting how the world's slavery was pretty well abolished during the last three centuries after being tolerated for a great many previous centuries during which it coexisted with the world's major religions. My guess is that Kantian Fairness Tendency was a major contributor to this result.

8. Envy/Jealousy Tendency

A member of a species designed through evolutionary process to want often-scarce food is going to be driven strongly toward getting food when it first sees food. And this is going to occur often and tend to create some conflict when the food is seen in the possession of another member of the same species. This is probably the evolutionary origin of the Envy/Jealousy Tendency that lies so deep in human nature. Sibling jealousy is clearly very strong and usually greater in children than adults. It is often stronger than jealousy directed at strangers. Kantian Fairness Tendency probably contributes to this result.

Envy/jealousy is extreme in myth, religion, and literature wherein, in account after account, it triggers hatred and injury. It was regarded as so pernicious by the Jews of the civilization that preceded Christ that it was forbidden, by phrase after phrase, in the laws of Moses. You were even warned by the Prophet not to covet your neighbor's donkey.

And envy/jealousy is also extreme in modern life. For instance, university communities often go bananas when some university employee in money management, or some professor in surgery, gets annual compensation in multiples of the standard professorial salary. And in modern investment banks, law firms, etc., the envy/jealousy effects are usually more extreme than they are in university faculties. Many big law firms, fearing disorder from envy/jealousy, have long treated all senior partners alike in compensation, no matter how different their contributions to firm welfare. As I have shared the observation of life with Warren Buffett over decades, I have heard him wisely say on several occasions: "It is not greed that drives the world, but envy."

And, because this is roughly right, one would expect a vast coverage of envy/jealousy in psychology textbooks. But no such vast coverage existed when I read my three textbooks. Indeed, the very words "envy" and "jealousy" were often absent from the index.

Nondiscussion of envy/jealousy is not a phenomenon confined to psychology texts. When did any of you last engage in any large group discussion of some issue wherein adult envy/jealousy was identified as the cause of someone's argument? There seems to be a general taboo against any such claim. If so, what accounts for the taboo?

My guess is that people widely and generally sense that labeling some position as driven by envy/jealousy will be regarded as extremely insulting to the position taker, possibly more so when the diagnosis is correct than when it is wrong. And if calling a position "envy-driven" is perceived as the equivalent of describing its holder as a childish mental basket case, then it is quite understandable how a general taboo has arisen.

But should this general taboo extend to psychology texts when it creates such a large gap in the correct, psychological explanation of what is widespread and important? My answer is no.

9. Reciprocation Tendency

The automatic tendency of humans to reciprocate both favors and disfavors has long been noticed as it is in apes, monkeys, dogs, and many less cognitively gifted animals. The tendency facilitates group cooperation for the benefit of members. In this respect, it mimics much genetic programming of the social insects. We see the extreme power of the tendency to reciprocate disfavors in some wars, wherein it increases hatred to a level causing very brutal conduct. For long stretches in many wars, no prisoners were taken; the only acceptable enemy a dead one. And sometimes that was not enough, as in the case of Genghis Khan, who was not satisfied with corpses. He insisted on their being hacked into pieces.

One interesting mental exercise is to compare Genghis Khan, who exercised extreme, lethal hostility toward other men, with ants that display extreme, lethal hostility toward members of their own species that are not part of their breeding colony. Genghis looks sweetly lovable when compared to the ants. The ants are more disposed to fight and fight with more extreme cruelty.

Indeed, E. O. Wilson once waggishly suggested that if ants were suddenly to get atom bombs, all ants would be dead within eighteen hours. What both human and ant history suggest is

1) that nature has no general algorithm making intra-species, turn-the-other-cheek behavior a booster of species survival;
2) that it is not clear that a country would have good prospects were it to abandon all reciprocate-disfavor tendency directed at outsiders; and
3) if turn-the-other-cheek behavior is a good idea for a country as it deals with outsiders, man's culture is going to have to do a lot of heavy lifting because his genes won't be of much help.

I next turn to man's reciprocated hostility that falls well short of war. Peacetime hostility can be pretty extreme, as in many modern cases of "road rage" or injury-producing temper tantrums on athletic fields.

The standard antidote to one's overactive hostility is to train oneself to defer reaction. As my smart friend Tom Murphy so frequently says, "You can always tell the man off tomorrow, if it is such a good idea."

Of course, the tendency to reciprocate favor for favor is also very intense, so much so that it occasionally reverses the course of reciprocated hostility. Weird pauses in fighting have sometimes occurred right in the middle of wars, triggered by some minor courtesy or favor on the part of one side, followed by favor reciprocation from the other side, and so on, until fighting stopped for a considerable period. This happened more than once in the trench warfare of World War I, over big stretches of the front and much to the dismay of the generals.

It is obvious that commercial trade, a fundamental cause of modern prosperity, is enormously facilitated by man's innate tendency to reciprocate favors. In trade, enlightened self-interest joining with Reciprocation Tendency results in constructive conduct. Daily interchange in marriage is also assisted by Reciprocation Tendency, without which marriage would lose much of its allure.

And Reciprocation Tendency, insomuch as it causes good results, does not join forces only with the superpower of incentives. It also joins Inconsistency-Avoidance Tendency in helping cause:

1) the fulfillment of promises made as part of a bargain, including loyalty promises in marriage ceremonies, and
2) correct behavior expected from persons serving as priests, shoemakers, physicians, and all else.

Like other psychological tendencies, and also man's ability to turn somersaults, reciprocate-favor tendency operates to a very considerable degree at a subconscious level. This helps make the tendency a strong force that can sometimes be used by some men to mislead others, which happens all the time.

For instance, when an automobile salesman graciously steers you into a comfortable place to sit and gives you a cup of coffee, you are very likely being tricked, by this small courtesy alone, into parting with an extra five hundred dollars. This is far from the most extreme case of sales success that is rooted in a salesman dispensing minor favors. However, in this scenario of buying a car, you are going to be disadvantaged by parting with an extra five hundred dollars of your own money. This potential loss will protect you to some extent.

But suppose you are the purchasing agent of someone else – a rich employer, for instance. Now the minor favor you receive from the salesman is less opposed by the threat of extra cost to you because someone else is paying the extra cost. Under such circumstances, the salesman is often able to maximize his advantage, particularly when government is the purchaser.

Wise employers, therefore, try to oppose reciprocate-favor tendencies of employees engaged in purchasing. The simplest antidote works best: Don't let them accept any favors from vendors. Sam Walton agreed with this idea of absolute prohibition. He wouldn't let purchasing agents accept so much as a hot dog from a vendor. Given the subconscious level at which much Reciprocation Tendency operates, this policy of Walton's was profoundly correct. If I controlled the Defense Department, its policies would mimic Walton's.

In a famous psychology experiment, Cialdini brilliantly demonstrated the power of "compliance practitioners" to mislead people by triggering their subconscious Reciprocation Tendency.

Carrying out this experiment, Cialdini caused his "compliance practitioners" to wander around his campus and ask strangers to supervise a bunch of juvenile delinquents on a trip to a zoo. Because this happed on a campus, one person in six out of a large sample actually agreed to do this. After accumulating this one-in-six statistic, Cialdini changed his procedure. His practitioners next wandered around the campus asking strangers to devote a big chunk of time every week for two years to the supervision of juvenile delinquents. This ridiculous request got him a one hundred percent rejection rate. But the practitioner had a follow-up question: "Will you at least spend one afternoon taking juvenile delinquents to a zoo?" This raised Cialdini's former acceptance rate of 1/6 to ½ – a tripling.

What Cialdini's "compliance practitioners" had done was make a small concession, which was reciprocated by a small concession from the other side. This subconscious reciprocation of a concession by Cialdini's experimental subjects actually caused a much increased percentage of them to end up irrationally agreeing to go to a zoo with juvenile delinquents. Now, a professor who can invent an experiment like that, which so powerfully demonstrates something so important, deserves much recognition in the wider world, which he indeed got to the credit of many universities that learned a great

deal from Cialdini.

Why is Reciprocation Tendency so important? Well, consider the folly of having law students graduate, and go out in the world representing clients in negotiations, not knowing the nature of the subconscious processes of the mind as exhibited in Cialdini's experiment. Yet such folly was prevalent in the law schools of the world for decades, in fact, generations. The correct name for that is educational malpractice. The law schools didn't know, or care to teach, what Sam Walton so well knew.

The importance and power of reciprocate-favor tendency was also demonstrated in Cialdini's explanation of the foolish decision of the attorney general of the United States to authorize the Watergate burglary. There, an aggressive subordinate made some extreme proposal for advancing Republican interests through use of some combination of whores and a gigantic yacht. When this ridiculous request was rejected, the subordinate backed off, in gracious concession, to merely asking for consent to a burglary, and the attorney general went along. Cialdini believes that subconscious Reciprocation Tendency thus became one important cause of the resignation of a United States president in the Watergate debacle, and so do I. Reciprocation Tendency subtly causes many extreme and dangerous consequences, not just on rare occasions but pretty much all the time.

Man's belief in reciprocate-favor tendency, following eons of his practicing it, has done some queer and bad things in religions. The ritualized murder of the Phoenicians and the Aztecs, in which they sacrificed human victims to their gods, was a particularly egregious example. And we should not forget that as late as the Punic Wars, the civilized Romans, out of fear of defeat, returned in a few instances to the practice of human sacrifice. On the other hand, the reciprocity-based, religion-boosting idea of obtaining help from God in reciprocation for good human behavior has probably been vastly constructive.

Overall, both inside and outside religions, it seems clear to me that Reciprocation Tendency's constructive contributions to man far outweigh its destructive effects. In cases of psychological tendencies being used to counter or prevent bad results from one or more other psychological tendencies – for instance, in the case of interventions to end chemical dependency – you will usually find Reciprocation Tendency performing strongly on the constructive side.

And the very best part of human life probably lies in relationships of affection wherein parties are more interested in pleasing than being pleased – a not uncommon outcome in display of reciprocate favor tendency.

Before we leave reciprocate-favor tendency, the final phenomenon we will consider is widespread human misery from feelings of guilt. To the extent the feeling of guilt has an evolutionary base, I believe the most plausible cause is the mental conflict triggered in one direction by reciprocate favor tendency and in the opposite direction by Reward Superresponse Tendency pushing one to enjoy one hundred percent of some good thing. Of course, human culture has often greatly boosted the genetic tendency to suffer from feelings of guilt. Most especially, religious culture has imposed hard-to-follow ethical and devotional demands on people. There is a charming Irish Catholic priest in my neighborhood who, with rough accuracy, often says, "The old Jews may have invented guilt, but we Catholics perfected it." And if you, like me and this priest, believe that, averaged out, feelings of guilt do more good than harm, you may join in my special gratitude for reciprocate-favor tendency, no matter how unpleasant you find feelings of guilt.

10. Influence-from-Mere-Association Tendency

In the standard conditioned reflexes studied by Skinner and most common in the world, responsive behavior, creating a new habit, is directly triggered by rewards previously bestowed. For instance, a man buys a can of branded shoe polish, has a good experience with it when shining his shoes, and because of this "reward," buys the same shoe polish when he needs another can.

But there is another type of conditioned reflex wherein mere association triggers a response. For instance, consider the case of many men who have been trained by their previous experience in life to believe that when several similar items are presented for purchase, the one with the highest price will have the highest quality. Knowing this, some seller of an ordinary industrial product will often change his product's trade dress and raise its price significantly hoping that quality-seeking buyers will be tricked into becoming purchasers by mere association of his product and its high price. This industrial practice frequently is effective in driving up sales and even more so in driving up profits. For instance, it worked wonderfully with high-priced power tools for a long time. And it would work better yet with highpriced pumps at the bottom of oil wells. With luxury goods, the process works with a special boost because buyers who pay high prices often gain extra status from thus demonstrating both their good taste and their ability to pay.

Even association that appears to be trivial, if carefully planned, can have extreme and peculiar effects on purchasers of products. The target purchaser of shoe polish may like pretty girls. And so he chooses the polish with the pretty girl on the can or the one with the pretty girl in the last ad for shoe polish that he saw.

Advertisers know about the power of mere association. You won't see Coke advertised alongside some account of the death of a child. Instead, Coke ads picture life as happier than reality.

Similarly, it is not from mere chance that military bands play such impressive music. That kind of music, appearing in mere association with military service, helps

to attract soldiers and keep them in the army. Most armies have learned to use mere association in this successful way.

However, the most damaging miscalculations from mere association do not ordinarily come from advertisers and music providers.

Some of the most important miscalculations come from what is accidentally associated with one's past success, or one's liking and loving, or one's disliking and hating, which includes a natural hatred for bad news.

To avoid being misled by the mere association of some fact with past success, use this memory clue. Think of Napoleon and Hitler when they invaded Russia after using their armies with much success elsewhere. And there are plenty of mundane examples of results like those of Napoleon and Hitler. For instance, a man foolishly gambles in a casino and yet wins. This unlikely correlation causes him to try the casino again, or again and again, to his horrid detriment. Or a man gets lucky in an odds-against venture headed by an untalented friend. So influenced, he tries again what worked before – with terrible results.

The proper **antidotes** to being made such a patsy by past success are:

1) to carefully examine each past success, looking for accidental, noncausative factors associated with such success that will tend to mislead as one appraises odds implicit in a proposed new undertaking, and
2) to look for dangerous aspects of the new undertaking that were not present when past success occurred.

The damage to the mind that can come from liking and loving was once demonstrated by obviously false testimony given by an otherwise very admirable woman, the wife of a party in a jury case. The famous opposing counsel wanted to minimize his attack on such an admirable woman yet destroy the credibility of her testimony. And so, in his closing argument, he came to her testimony last. He then shook his head sadly and said, "What are we to make of such testimony? The answer lies in the old rhyme:

> As the husband is, So the wife is.
> She is married to a clown,
> And the grossness of his nature Drags her down."

The jury disbelieved the woman's testimony. They easily recognized the strong misinfluence of love on her cognition. And we now often see even stronger misinfluence from love as tearful mothers, with heartfelt conviction, declare before TV cameras the innocence of their obviously guilty sons.

People disagree about how much blindness should accompany the association called love. In *Poor Richard's Almanack* Franklin counseled: "Keep your eyes wide open before marriage and half shut thereafter." Perhaps this "eyes-half-shut" solution is about right, but I favor a tougher prescription: "See it like it is and love anyway."

Hating and disliking also cause miscalculation triggered by mere association. In business, I commonly see people underappraise both the competency and morals of competitors they dislike. This is a dangerous practice, usually disguised because it occurs on a subconscious basis.

Another common bad effect from the mere association of a person and a hated outcome is displayed in "Persian Messenger Syndrome." Ancient Persians actually killed some messengers whose sole fault was that they brought home truthful bad news, say, of a battle lost. It was actually safer for the messenger to run away and hide, instead of doing his job as a wiser boss would have wanted it done.

And Persian Messenger Syndrome is alive and well in modern life, albeit in less lethal versions. It is actually dangerous in many careers to be a carrier of unwelcome news. Union negotiators and employer representatives often know this, and it leads to many tragedies in labor relations. Sometimes lawyers, knowing their clients will hate them if they recommend an unwelcome but wise settlement, will carry on to disaster. Even in places well known for high cognition, one will sometimes find Persian Messenger Syndrome. For instance, years ago, two major oil companies litigated in a Texas trial court over some ambiguity in an operating agreement covering one of the largest oil reservoirs in the Western hemisphere. My guess is that the cause of the trial was some general counsel's unwillingness to carry bad news to a strong-minded CEO.

CBS, in its late heyday, was famous for occurrence of Persian Messenger Syndrome because Chairman Bill Paley was hostile to people who brought him bad news. The result was that Paley lived in a cocoon of unreality, from which he made one bad deal after another, even exchanging a large share of CBS for a company that had to be liquidated shortly thereafter.

The proper antidote to creating Persian Messenger Syndrome and its bad effects, like those at CBS, is to develop, through exercise of will, a habit of welcoming bad news. At Berkshire, there is a common injunction: "Always tell us the bad news promptly. It is only the good news that can wait." It also helps to be so wise and informed that people fear not telling you bad news because you are so likely to get it elsewhere.

Influence-from-Mere-Association Tendency often has a shocking effect that helps swamp the normal tendency to return favor for favor, [especially when the favor recipient's] condition is unpleasant, due to poverty, sickness, subjugation, or something else. Sometimes, when one receives a favor, the favor may trigger an envy-driven dislike for the person who was in so favorable a state that he could easily be a favor giver. Under such circumstances, the favor receiver, prompted partly by mere association of the favor giver with past

pain, will not only dislike the man who helped him but also try to injure him. This accounts for a famous response, sometimes dubiously attributed to Henry Ford: "Why does that man hate me so? I never did anything for him."

I have a friend, whom I will now call "Glotz," who had an amusing experience in favor-giving. Glotz owned an apartment building that he had bought because he wanted, eventually, to use the land in different development. Pending this outcome, Glotz was very lenient in collecting below-market rents from tenants. When, at last, there was a public hearing on Glotz's proposal to tear down the building, one tenant who was far behind in his rent payments was particularly angry and hostile. He came to the public hearing and said, "This proposal is outrageous. Glotz doesn't need any more money. I know this because I was supported in college by Glotz fellowships."

A final serious clump of bad thinking caused by mere association lies in the common use of classification stereotypes. Because Pete knows that Joe is ninety years old and that most ninety-year-old persons don't think very well, Pete appraises old Joe as a thinking klutz even if old Joe still thinks very well. Or, because Jane is a white-haired woman, and Pete knows no old women good at higher math, Pete appraises Jane as no good at it even if Jane is a whiz. This sort of wrong thinking is both natural and common. Pete's **antidote** is not to believe that, on average, ninety-year-olds think as well as forty year-olds or that there are as many females as males among Ph.D.'s in math. Instead, just as he must learn that trend does not always correctly predict destiny, he must learn that the average dimension in some group will not reliably guide him to the dimension of some specific item. Otherwise Pete will make many errors, like that of the fellow who drowned in a river that averaged out only eighteen inches deep.

11. Simple, Pain-Avoiding Psychological Denial

This phenomenon first hit me hard in World War II when the superathlete, superstudent son of a family friend flew off over the Atlantic Ocean and never came back. His mother, who was a very sane woman, then refused to believe he was dead. That's Simple, Pain-Avoiding Psychological Denial. The reality is too painful to bear, so one distorts the facts until they become bearable. We all do that to some extent, often causing terrible problems. The tendency's most extreme outcomes are usually mixed up with love, death, and chemical dependency.

Where denial is used to make dying easier, the conduct meets almost no criticism. Who would begrudge a fellow man such help at such a time? But some people hope to leave life hewing to the iron prescription, "It is not necessary to hope in order to persevere." And there is something admirable in anyone able to do this.

In chemical dependency, wherein morals usually break down horribly, addicted persons tend to believe that they remain in respectable condition, with respectable prospects. They thus display an extremely unrealistic denial of reality as they go deeper and deeper into deterioration. In my youth, Freudian remedies failed utterly in reversing chemical dependency, but nowadays Alcoholics Anonymous routinely achieves a fifty percent cure rate by causing several psychological tendencies to act together to counter addiction. However, the cure process is typically difficult and draining, and a fifty percent success rate implies a fifty percent failure rate. One should stay far away from any conduct at all likely to drift into chemical dependency. Even a small chance of suffering so great a damage should be avoided.

12. Excessive Self-Regard Tendency

We all commonly observe the excessive self-regard of man. He mostly misappraises himself on the high side, like the ninety percent of Swedish drivers that judge themselves to be above average. Such misappraisals also apply to a person's major "possessions." One spouse usually overappraises the other spouse. And a man's children are likewise appraised higher by him than they are likely to be in a more objective view. Even man's minor possessions tend to be overappraised. Once owned, they suddenly become worth more to him than he would pay if they were offered for sale to him and he didn't already own them. There is a name in psychology for this overappraisal-of-our-own-possessions phenomenon: the "endowment effect." And all man's decisions are suddenly regarded by him as better than would have been the case just before he made them.

Man's excess of self-regard typically makes him strongly prefer people like himself. Psychology professors have had much fun demonstrating this effect in "lost-wallet" experiments. Their experiments all show that the finder of a lost wallet containing identity clues will be most likely to return the wallet when the owner most closely resembles the finder. Given this quality in psychosocial nature, cliquish groups of similar persons will always be a very influential part of human culture, even after we wisely try to dampen the worst effects.

Some of the worst consequences in modern life come when dysfunctional groups of cliquish persons, dominated by Excessive Self-Regard Tendency, select as new members of their organizations persons who are very much like themselves. Thus if the English department at an elite university becomes mentally dysfunctional or the sales department of a brokerage firm slips into routine fraud, the problem will have a natural tendency to get worse and to be quite resistant to change for the better. So also with a police department or prison-guard unit or political group gone sour and countless other places mired in evil and folly, such as the worst of our big-city teachers' unions that harm our children by preventing discharge of ineffective teachers.

Therefore, some of the most useful members of our civilization are those who are willing to "clean house" when they find a mess under their ambit of control.

Well, naturally, all forms of excess of self-regard cause much error. How could it be otherwise?

Let us consider some foolish gambling decisions. In lotteries, the play is much lower when numbers are distributed randomly than it is when the player picks his own number. This is quite irrational. The odds are almost exactly the same and much against the player. Because state lotteries take advantage of man's irrational love of self-picked numbers, modern man buys more lottery tickets than he otherwise would have, with each purchase foolish.

Intensify man's love of his own conclusions by adding the possessory wallop from the "endowment effect," and you will find that a man who has already bought a pork-belly future on a commodity exchange now foolishly believes, even more strongly than before, in the merits of his speculative bet.

And foolish sports betting, by people who love sports and think they know a lot about relative merits of teams, is a lot more addictive than race track betting – partly because of man's automatic overappraisal of his own complicated conclusions.

Also extremely counterproductive is man's tendency to bet, time after time, in games of skill, like golf or poker, against people who are obviously much better players. Excessive Self-Regard Tendency diminishes the foolish bettor's accuracy in appraising his relative degree of talent.

More counterproductive yet are man's appraisals, typically excessive, of the quality of the future service he is to provide to his business. His overappraisal of these prospective contributions will frequently cause disaster.

Excesses of self-regard often cause bad hiring decisions because employers grossly overappraise the worth of their own conclusions that rely on impressions in face-to-face contact. The correct antidote to this sort of folly is to underweigh face-to-face impressions and overweigh the applicant's past record.

I once chose exactly this course of action while I served as chairman of an academic search committee. I convinced fellow committee members to stop all further interviews and simply appoint a person whose achievement record was much better than that of any other applicant. And when it was suggested to me that I wasn't giving "academic due process," I replied that I was the one being true to academic values because I was using academic research showing poor predictive value of impressions from face-to-face interviews.

Because man is likely to be overinfluenced by face-to-face impressions that by definition involve his active participation, a job candidate who is a marvelous "presenter" often causes great danger under modern executive-search practice. In my opinion, Hewlett-Packard faced just such a danger when it interviewed the articulate, dynamic Carly Fiorina in its search for a new CEO. And I believe that Hewlett-Packard made a bad decision when it chose Ms. Fiorina, and that this bad decision would not have been made if Hewlett-Packard had taken the methodological precautions it would have taken if it knew more psychology.

There is a famous passage somewhere in Tolstoy that illuminates the power of Excessive Self-Regard Tendency. According to Tolstoy, the worst criminals don't appraise themselves as all that bad. They come to believe either (1) that they didn't commit their crimes or (2) that, considering the pressures and disadvantages of their lives, it is understandable and forgivable that they behaved as they did and became what they became.

The second half of the "Tolstoy effect," where the man makes excuses for his fixable poor performance, instead of providing the fix, is enormously important. Because a majority of mankind will try to get along by making way too many unreasonable excuses for fixable poor performance, it is very important to have personal and institutional **antidotes** limiting the ravages of such folly. On the personal level a man should try to face the two simple facts:

1) fixable but unfixed bad performance is bad character and tends to create more of itself, causing more damage to the excuse giver with each tolerated instance, and
2) in demanding places, like athletic teams and General Electric, you are almost sure to be discarded in due course if you keep giving excuses instead of behaving as you should.

The main institutional **antidotes** to this part of the "Tolstoy effect" are:

1) a fair, meritocratic, demanding culture plus personnel handling methods that build up morale, and
2) severance of the worst offenders.

Of course, when you can't sever – as in the case of your own child – you must try to fix the child as best you can. I once heard of child-teaching method so effective that the child remembered the learning experience over fifty years later. The child later became Dean of the USC School of Music and then related to me what father said when he saw his child taking candy from the stock of his employer with the excuse that he intended to replace it later. The father said, "Son, it would be better for you to simply take all you want and call yourself a thief every time you do it."

The best **antidote** to folly from an excess of self-regard is to force yourself to be more objective when you are thinking about yourself, your family and friends, your property, and the value of your past and future activity. This isn't easy to do well won't work perfectly, but it will work much better than simply letting psychological nature take its normal course.

While an excess of self-regard is often counterproductive in its effects on cognition, it can cause some weird successes from overconfidence that happens to

cause success. This factor accounts for the adage: "Never underestimate the man who overestimates himself."

Of course, some high self-appraisals are correct and serve better than false modesty. Moreover, self-regard in the form of a justified pride in a job well done, or a life well lived, is a large constructive force. Without such justified pride, many more airplanes would crash. "Pride" is another word generally left out of psychology textbooks, and this omission is not a good idea. It is also not a good idea to construe the bible's parable about the Pharisee and the Publican as condemning all pride.

Of all forms of useful pride, perhaps the most desirable is a justified pride in being trustworthy. Moreover, the trustworthy man, even after allowing for the inconveniences of his chosen course, ordinarily has a life that averages out better than he would have if he provided less reliability.

13. Overoptimism Tendency

About three centuries before the birth of Christ, Demosthenes, the most famous Greek orator, said, "What a man wishes, that also will he believe."

Demosthenes, parsed out, was thus saying that man displays not only Simple, Pain-Avoiding Psychological Denial but also an excess of optimism even when he is already doing well.

The Greek orator was clearly right about an excess of optimism being the normal human condition, even when pain or the threat of pain is absent. Witness happy people buying lottery tickets or believing that credit-furnishing, delivery-making grocery stores were going to displace a great many superefficient cash-and-carry supermarkets.

One standard **antidote** to foolish optimism is trained, habitual use of the simple probability math of Fermat and Pascal, taught in my youth to high school sophomores. The mental rules of thumb that evolution gives you to deal with risk are not adequate. They resemble the dysfunctional golf grip you would have if you relied on a grip driven by evolution instead of golf lessons.

14. Deprival Superreaction Tendency

The quantity of man's pleasure from a ten dollar gain does not exactly match the quantity of his displeasure from a ten-dollar loss. That is, the loss seems to hurt much more than the gain seems to help. Moreover, if a man almost gets something he greatly wants and has it jerked away from him at the last moment, he will react much as if he had long owned the reward and had it jerked away. I include the natural human reactions to both kind of loss experience – the loss of the possessed reward and the loss of the almost-possessed reward – under one description, Deprival Superreaction Tendency.

In displaying Deprival Superreaction Tendency, man frequently incurs disadvantage by misframing his problems. He will often compare what is near instead of what really matters. For instance, a man with $10 million in his brokerage account will often be extremely irritated by the accidental loss of $100 out of the $300 in his wallet.

The Mungers once owned a tame and good-natured dog that displayed the canine version of Deprival Superreaction Tendency. There was only one way to get bitten by this dog. And that was to try and take some food away from him after he already had it in his mouth. If you did that, this friendly dog would automatically bite. He couldn't help it. Nothing could be more stupid than for the dog to bite his master. But the dog couldn't help being foolish. He had an automatic Deprival Superreaction Tendency in his nature.

Humans are much the same as this Munger dog. A man ordinarily reacts with irrational intensity to even a small loss, or threatened loss, of property, love, friendship, dominated territory, opportunity: status, or any other valued thing. As a natural result, bureaucratic infighting over the threatened loss of dominated territory often causes immense damage to an institution as a whole. This factor among others, accounts for much of the wisdom of Jack Welch's long fight against bureaucratic ills at General Electric. Few business leaders have ever conducted wiser campaigns.

Deprival Superreaction Tendency often protects ideological or religious views by triggering and hatred directed toward vocal nonbelievers. This happens, in part, because the ideas of the nonbelievers, if they spread, will diminish the influence of views that are now supported by a comfortable environment including a strong relief-maintenance system. University liberal arts departments, law schools, and business organizations all display plenty of such ideology-based groupthink that rejects almost all conflicting inputs. When the vocal critic is a former believer, hostility is often boosted both by:

1) a concept of betrayal that triggers additional Deprival Superreaction Tendency because a colleague is lost, and
2) fears that conflicting views will have extra persuasive power when they come from a former colleague.

The foregoing considerations help account for the old idea of heresy, which for centuries justified much killing of heretics, frequently after torture and frequently accomplished by burning the victim alive.

It is almost everywhere the case that extremes of ideology are maintained with great intensity and with great antipathy to non-believers, causing extremes of cognitive dysfunction. This happens, I believe, because two psychological tendencies are usually acting concurrently toward this same sad result: Inconsistency-Avoidance Tendency, plus Deprival Superreaction Tendency.

One **antidote** to intense, deliberate maintenance of groupthink is an extreme culture of courtesy, kept in place despite ideological differences, like the behavior of the justices now serving on the U.S. Supreme Court. Another antidote is to deliberately bring in able and articulate disbelievers of incumbent groupthink. Successful corrective measures to evil examples of groupthink maintenance have included actions like that of Derek Bok when, as president of Harvard, he started disapproving tenure appointments proposed by ideologues at Harvard Law School.

Even a one-degree loss from a 180-degree view will sometime create enough Deprival Superreaction Tendency to turn a neighbor into an enemy, as I once observed when I bought a house from one of two neighbors locked into hatred by a tiny tree newly installed by one of them.

As the case of these two neighbors illustrated, the clamor of almost any group of neighbors displaying irrational, extreme deprival superreaction over some trifle in a zoning hearing is not a pretty thing to watch. Such bad behavior drives some people from the zoning field. I once bought some golf clubs from an artisan who was formerly a lawyer. When I asked him what kind of law he had practiced, I expected to hear him say, "divorce law" But his answer was, "zoning law."

Deprival Superreaction Tendency has ghastly effects in labor relations. Most of the deaths in the labor strife that occurred before World War I came when employers tried to reduce wages. Nowadays, we see fewer deaths and more occasions when whole companies disappear, as competition requires either takeaways from labor – which it will not consent to – or death of the business. Deprival Superreaction Tendency causes much of this labor resistance, often in cases where it would be in labor's interest to make a different decision.

In contexts other than labor relations, takeaways are also difficult to get. Many tragedies, therefore, occur that would have been avoided had there been more rationality and less subconscious heed of the imperative from Deprival Superreaction Tendency.

Deprival Superreaction Tendency and Inconsistency-Avoidance Tendency often join to cause one form of business failure. In this form of ruin, a man gradually uses up all his good assets in a fruitless attempt to rescue a big venture going bad. One of the best **antidotes** to this folly is good poker skill learned young. The teaching value of poker demonstrates that not all effective teaching occurs on a standard academic path.

Deprival Superreaction Tendency is also a huge contributor to ruin from compulsion to gamble. First, it causes the gambler to have a passion to get even once he has suffered loss, and the passion grows with the loss. Second, the most addictive forms of gambling provide a lot of near misses and each one triggers Deprival Superreaction Tendency. Some slot machine creators are vicious in exploiting this weakness of man. Electronic machines enable these creators to produce a lot of meaningless bar-bar-lemon results that greatly increase play by fools who think they have very nearly won large rewards.

Deprival Superreaction Tendency often does much damage to man in open-outcry auctions. The "social proof" that we will next consider tends to convince man that the last price from another bidder was reasonable, and then Deprival Superreaction Tendency prompts him strongly to top the last bid. The best **antidote** to being thus triggered into paying foolish prices at open-outcry auctions is the simple Buffett practice: Don't go to such auctions.

I myself, the would-be instructor here, many decades ago made a big mistake caused in part by subconscious operation of my Deprival Superreaction Tendency. A friendly broker called and offered me 300 shares of ridiculously underpriced, very thinly traded Belridge Oil at $115 per share, which I purchased using cash I had on hand. The next day, he offered me 1,500 more shares at the same price, which I declined to buy, partly because I could only have made the purchase had I sold something or borrowed the required $173,000. This was a very irrational decision. I was a well-to-do man with no debt; there was no risk of loss; and similar no risk opportunities were not likely to come along. Within two years, Belridge Oil sold out to Shell at a price of about $3,700 per share, which made me about $5.4 million poorer than I would have been had I then been psychologically acute. As this tale demonstrates, psychological ignorance can be very expensive.

Some people may question my defining Deprival Superreaction Tendency to include reaction to profit barely missed, as in the well-documented responses of slot machine players. However, I believe that I haven't defined the tendency as broadly as I should. My reason for suggesting an even broader definition is that many Berkshire Hathaway shareholders I know never sell or give away a single share after immense gains in market value have occurred. Some of this reaction is caused by rational calculation, and some is, no doubt, attributable to some combination of (1) reward superresponse, (2) "status quo bias" from Inconsistency-Avoidance Tendency, and (3) "the endowment effect" from Excessive Self-Regard Tendency. But I believe the single strongest irrational explanation is a form of Deprival Superreaction Tendency. Many of these shareholders simply can't stand the idea of having their Berkshire Hathaway holdings smaller. Partly they dislike facing what they consider an impairment of identity, but mostly they fear missing out on future gains from stock sold or given away.

15. Social-Proof Tendency

The otherwise complex behavior of man is much simplified when he automatically thinks and does what he observes to be thought and done around him. And such followership often works fine. For instance, what sim-

pler way could there be to find out how to walk to a big football game in a strange city than by following the flow of the crowd. For some such reason, man's evolution left him with Social-Proof Tendency, an automatic tendency to think and act as he sees others around him thinking and acting.

Psychology professors love Social-Proof Tendency because in their experiments it causes ridiculous results. For instance, if a professor arranges for some stranger to enter an elevator wherein ten "compliance practitioners" are all silently standing so that they face the rear of the elevator, the stranger will often turn around and do the same. The psychology professors can also use Social-Proof Tendency to cause people to make large and ridiculous measurement errors.

And, of course, teenagers' parents usually learn more than they would like about teenagers' cognitive errors from Social-Proof Tendency. This phenomenon was recently involved in a breakthrough by Judith Rich Harris who demonstrated that superrespect by young people for their peers, rather than for parents or other adults, is ordained to some considerable extent by the genes of the young people. This makes it wise for parents to rely more on manipulating the quality of the peers than on exhortations to their own offspring. A person like Ms. Harris, who can provide an insight of this quality and utility, backed by new reasons, has not lived in vain.

And in the highest reaches of business, it is not all uncommon to find leaders who display followership akin to that of teenagers. If one oil company foolishly buys a mine, other oil companies often quickly join in buying mines. So also if the purchased company makes fertilizer. Both of these oil company buying fads actually bloomed, with bad results.

Of course, it is difficult to identify and correctly weigh all the possible ways to deploy the cash flow of an oil company. So oil company executives, like everyone else, have made many bad decisions that were quickly triggered by discomfort from doubt. Going along with social proof provided by the action of other oil companies ends this discomfort in a natural way.

When will Social-Proof Tendency be most easily triggered? Here the answer is clear from many experiments: Triggering most readily occurs in the presence of puzzlement or stress, and particularly when both exist.

Because stress intensifies Social-Proof Tendency, disreputable sales organizations, engaged, for instance, in such action as selling swampland to schoolteachers, manipulate targets into situations combining isolation and stress. The isolation strengthens the social proof provided by both the knaves and the people who buy first, and the stress, often increased by fatigue, augments the targets' susceptibility to the social proof. And, of course, the techniques of our worst "religious" cults imitate those of the knavish salesmen. One cult even used rattlesnakes to heighten the stress felt by conversion targets.

Because both bad and good behavior are made contagious by Social-Proof Tendency, it is highly important that human societies stop any bad behavior before it spreads and foster and display all good behavior.

My father once told me that just after commencing law practice in Omaha, he went with a large group from Nebraska to South Dakota to hunt pheasants. A South Dakota hunting license was, say, $2 for South Dakota residents and $5 for nonresidents. All the Nebraska residents, one by one, signed up for South Dakota licenses with phony South Dakota addresses until it was my father's turn. Then, according to him, he barely prevented himself from doing what the others were doing, which was some sort of criminal offense.

Not everyone so resists the social contagion of bad behavior. And, therefore, we often get "Serpico Syndrome," named to commemorate the state of a near-totally corrupt New York police division joined by Frank Serpico. He was then nearly murdered by gunfire because of his resistance to going along with the corruption in the division. Such corruption was being driven by social proof plus incentives, the combination that creates Serpico Syndrome. The Serpico story should be taught more than it now is because the didactic power of its horror is aimed at a very important evil, driven substantially by a very important force: social proof.

In social proof, it is not only action by others that misleads but also their inaction. In the presence of doubt, inaction by others becomes social proof that inaction is the right course. Thus, the inaction of a great many bystanders led to the death of Kitty Genovese in a famous incident much discussed in introductory psychology courses.

In the ambit of social proof, the outside rectors on a corporate board usually display the near ultimate form of inaction. They fail to object to anything much short of an axe murder until some public embarrassment of the board finally causes their intervention. A typical board-of-directors' culture was once well described by my friend, Joe Rosenfield, as he said, "They asked me if I wanted become a director of Northwest Bell, and it was the last thing they ever asked me."

In advertising and sales promotion, Social-Proof Tendency is about as strong a factor as one could imagine. "Monkey-see, monkey-do" is the old phrase that reminds one of how strongly John will often wish to do something, or have something, just because Joe does or has it. One interesting consequence is that an advertiser will pay a lot to have its soup can, instead of someone else's, in a movie scene involving soup consumption only in a peripheral way.

Social-Proof Tendency often interacts in a perverse way with Envy/Jealousy and Deprival Superreaction Tendency. One such interaction amused my family for years as people recalled the time when my cousin Russ and I, at ages three and four, fought and howled over a

single surplus shingle while surrounded by a virtual sea of surplus shingles.

But the adult versions of this occasion, boosted by psychological tendencies preserving ideologies, are not funny – and can bring down whole civilizations. The Middle East now presents just such a threat. By now the resources spent by Jews, Arabs and all others over a small amount of disputed land if divided arbitrarily among land claimants, would have made everyone better off, even before taking into account any benefit from reduced threat of war, possibly nuclear.

Outside domestic relations it is rare now to try to resolve disputes by techniques including discussion of impacts from psychological tendencies. Considering the implications of childishness that would be raised by such inclusion, and the defects of psychology as now taught, this result may be sound. But, given the nuclear stakes now involved and the many failures in important negotiations lasting decades, I often wonder if some day, in some way, more use of psychological insight will eventually improve outcomes. If so, correct teaching of psychology matters a lot. And, if old psychology professors are even less likely than old physics professors to learn new ways, which seems nearly certain, then we may, as Max Planck predicted, need a new generation of psychology professors who have grown up to think in a different way.

If only one lesson is to be chosen from a package of lessons involving Social-Proof Tendency, and used in self improvement, my favorite would be: Learn how to ignore the examples from otbers when they are wrong, because few skills are more worth having.

16. Contrast-Misreaction Tendency

Because the nervous system of man does not naturally measure in absolute scientific units, it must instead rely on something simpler. The eyes have a solution that limits their programming needs: the contrast in what is seen is registered. And as in sight, so does it go, largely, in the other senses. Moreover, as perception goes, so goes cognition. The result is man's Contrast-Misreaction Tendency. Few psychological tendencies do more damage to correct thinking. Small-scale damages involve instances such as man's buying an overpriced $1,000 leather dashboard merely because the price is so low compared to his concurrent purchase of a $65,000 car. Large-scale damages often ruin lives, as when a wonderful woman having terrible parents marries a man who would be judged satisfactory only in comparison to her parents. Or as when a man takes wife number two who would be appraised as all right only in comparison to wife number one.

A particularly reprehensible form of sales practice occurs in the offices of some real estate brokers. A buyer from out of the city, perhaps needing to shift his family there, visits the office with little time available. The salesman deliberately shows the customer three awful houses at ridiculously high prices. Then he shows him a merely bad house at a price only moderately too high. And, boom, the broker often makes an easy sale.

Contrast-Misreaction Tendency is routinely used to cause disadvantage for customers buying merchandise and services. To make an ordinary price seem low, the vendor will very frequently create a highly artificial price that is much higher than the price always sought, then advertise his standard price as a big reduction from his phony price. Even when people know that this sort of customer manipulation is being attempted, it will often work to trigger buying. This phenomenon accounts in part for much advertising in newspapers. It also demonstrates that being aware of psychological ploys is not a perfect defense. When a man's steps are consecutively taken toward disaster, with each step being very small, the brain's Contrast-Misreaction Tendency will often let the man go too far toward disaster to be able to avoid it. This happens because each step presents small a contrast from his present position.

A bridge-playing pal of mine once told me that a frog tossed into very hot water would jump out, but that the same frog would end up dying if placed in room-temperature water that was later treated at a very slow rate. My few shreds of physiological knowledge make me doubt this account. But no matter, because many businesses die in just the manner claimed by my friend for the frog. Cognition, misled by tiny changes involving low contrast, will often miss a trend that is destiny.

One of Ben Franklin's best-remembered and most useful aphorisms is "A small leak will sink great ship." The utility of the aphorism is large precisely because the brain so often misses the functional equivalent of a small leak in a great ship.

17. Stress-Influence Tendency

Everyone recognizes that sudden stress, for instance from a threat, will cause a rush of adrenaline in the human body, prompting faster and more extreme reaction. And everyone who has taken Psych 101 knows that stress makes Social-Proof Tendency more powerful.

In a phenomenon less well recognized, but still widely known, light stress can slightly improve performance – say, in examinations – whereas heavy stress causes dysfunction.

But few people know more about really heavy stress than that it can cause depression. For instance, most people know that an "acute stress depression" makes thinking dysfunctional because it causes an extreme of pessimism, often extended in length and usually accompanied by activity stopping fatigue. Fortunately, as most people also know, such a depression is one of mankind's more reversible ailments. Even before modern drugs were available, many people afflicted by depression, such as Winston Churchill and Samuel Johnson, gained great achievement in life.

Most people know very little about nondepressive

mental breakdowns influenced by heavy stress. But there is at least one exception, involving the work of Pavlov when he was in his seventies and eighties. Pavlov had won a Nobel Prize early in life by using dogs to work out the physiology of digestion. Then he became world-famous by working out mere-association responses in dogs, initially salivating dogs – so much so that changes in behavior triggered by mere-association, like those caused by much modern advertisement, are today often said to come from "Pavlovian" conditioning.

What happened to cause Pavlov's last work was especially interesting. During the great Leningrad Flood of the 1920s, Pavlov had many dogs in cages. Their habits had been transformed, by a combination of his "Pavlovian conditioning" plus standard reward responses, into distinct and different patterns. As the waters of the flood came up and receded, many dogs reached a point where they had almost no airspace between their noses and the tops of their cages. This subjected them to maximum stress. Immediately thereafter, Pavlov noticed that many of the dogs were no longer behaving as they had. For example, the dog that formerly had liked his trainer now disliked him. This result reminds one of modern cognition-reversals in which a person's love of his parents suddenly becomes hate, as new love has been shifted suddenly to a cult. The unanticipated, extreme changes in Pavlov's dogs would have driven any good experimental scientist into a near-frenzy of curiosity. That was indeed Pavlov's reaction. But not many scientists would have done what Pavlov next did.

And that was to spend the rest of his long life giving stress-induced nervous breakdowns to dogs, after which he would try to reverse the breakdowns, all the while keeping careful experimental records. He found

1) that he could classify dogs so as to predict how easily a particular dog would breakdown;
2) that the dogs hardest to break down were also the hardest to return to their pre-breakdown state;
3) that any dog could be broken down; and
4) that he couldn't reverse a breakdown except by reimposing stress.

Now, practically everyone is revolted by such experimental treatment of man's friend, the dog. Moreover, Pavlov was Russian and did his last work under the Communists. And maybe those facts account for the present extreme, widespread ignorance of Pavlov's last work. The two Freudian psychiatrists with whom I tried many years ago to discuss this work had never heard of it. And the dean of a major medical school actually asked me, several years ago, if any of Pavlov's experiments were "repeatable" in experiments of other researchers. Obviously, Pavlov is now a sort of forgotten hero in medical science.

I first found a description of Pavlov's last work in a popular paperback, written by some Rockefeller-financed psychiatrist, when I was trying to figure out how cults worked their horrible mischief and what should the law say about what parents could do to "deprogram" children who had become brainwashed zombies. Naturally, mainstream law objected to the zombies being physically captured by their parents and subjected to stress that would help to deprogram the effects of the stress they had endured in cult conversions.

I never wanted to get into the legal controversy that existed about this subject. But I did conclude that the controversy couldn't be handled with maximized rationality without considering whether as Pavlov's last work suggests, the heavy-handed imposition of stress might be the only reversal method that would work to remedy one of the worst evils imaginable: a stolen mind. I have included this discussion of Pavlov partly out of general antagonism toward taboos, partly to make my talk reasonably complete as it considers stress and partly because I hope some listener may continue my inquiry with more success.

18. Availability-Misweighing Tendency

This mental tendency echoes the words of the song: "When I'm not near the girl I love, I love the girl I'm near." Man's imperfect, limited-capacity brain easily drifts into working with what's easily available to it. And the brain can't use what it can't remember or what it is blocked from recognizing because it is heavily influenced by one or more psychological tendencies bearing strongly on it, as the fellow is influenced by the nearby girl in the song. And so the mind overweighs what is easily available and thus displays Availability-Misweighing Tendency.

The main **antidotes** to miscues from Availability-Misweighing Tendency often involve procedures, including use of checklists, which are almost always helpful.

Another **antidote** is to behave somewhat like Darwin did when he emphasized disconfirming evidence. What should be done is to especially emphasize factors that don't produce reams of easily available numbers, instead of drifting mostly or entirely into considering factors that do produce such numbers. Still another antidote is to find and hire some skeptical, articulate people with far-reaching minds to act as advocates for notions that are opposite to the incumbent notions.

One consequence of this tendency is that extra vivid evidence, being so memorable and thus more available in cognition, should often consciously be underweighed while less vivid evidence should be overweighed.

Still, the special strength of extra-vivid images in influencing the mind can be constructively used

1) in persuading someone else to reach a correct conclusion or
2) as a device for improving one's own memory by attaching vivid images, one after the other, to many items one doesn't want to forget.

Indeed, such use of vivid images as memory boosters is

what enabled the great orators of classical Greece and Rome to give such long, organized speeches without using notes.

The great algorithm to remember in dealing with this tendency is simple: An idea or a fact is not worth more merely because it is easily available to you.

19. Use-It-or-Lose-It Tendency

All skills attenuate with disuse. I was a whiz at calculus until age twenty, after which the skill was soon obliterated by total nonuse. The right antidote to such a loss is to make use of the functional equivalent of the aircraft simulator employed in pilot training. This allows a pilot to continuously practice all of the rarely used skills that he can't afford to lose.

Throughout his life, a wise man engages in practice of all his useful, rarely used skills, many of them outside his discipline, as a sort of duty to his better self. If he reduces the number of skills he practices and, therefore, the number of skills he retains, he will naturally drift into error from man with a hammer tendency. His learning capacity will also shrink as he creates gaps in the latticework of theory he needs as a framework for understanding new experience. It is also essential for a thinking man to assemble his skills into a checklist that he routinely uses. Any other mode of operation will cause him to miss much that is important.

Skills of a very high order can be maintained only with daily practice. The pianist Paderewski once said that if he failed to practice for a single day, he could notice his performance deterioration and that, after a week's gap in practice, the audience could notice it as well.

The hard rule of Use-It-or-Lose-It Tendency tempers its harshness for the diligent. If a skill is raised to fluency, instead of merely being crammed in briefly to enable one to pass some test, then the skill (1) will be lost more slowly and (2) will come back faster when refreshed with new learning. These are not minor advantages, and a wise man engaged in learning some important skill will not stop until he is really fluent in it.

20. Drug-Misinfluence Tendency

This tendency's destructive power is so widely known to be intense, with frequent tragic consequences for cognition and the outcome of life, that it needs no discussion here to supplement that previously given under "Simple, Pain-Avoiding Psychological Denial."

21. Senescence-Misinfluence Tendency

With advanced age, there comes a natural cognitive decay, differing among individuals in the earliness of its arrival and the speed of its progression. Practically no one is good at learning complex new skills when very old. But some people remain pretty good in maintaining intensely practiced old skills until late in life, as one can notice in many a bridge tournament.

Old people like me get pretty skilled, without working at it, at disguising age-related deterioration because social convention, like clothing, hides much decline.

Continuous thinking and learning, done with joy, can somewhat help delay what is inevitable.

22. Authority-Misinfluence Tendency

Living in dominance hierarchies as he does, like all his ancestors before him, man was born mostly to follow leaders, with only a few people doing the leading. And so, human society is formally organized into dominance hierarchies, with their culture augmenting the natural follow-the-leader tendency of man.

But automatic as most human reactions are, with the tendency to follow leaders being no exception, man is often destined to suffer greatly when the leader is wrong or when his leader's ideas don't get through properly in the bustle of life and are misunderstood. And so, we find much miscognition from man's Authority-Misinfluence Tendency.

Some of the misinfluences are amusing, as in a case described by Cialdini. A physician left a written order for a nurse treating an earache, as follows: "Two drops, twice a day, r. ear." The nurse then directed the patient to turn over and put the eardrops in his anus.

Other versions of confused instructions from authority figures are tragic. In World War II, a new pilot for a general, who sat beside him in the copilot's seat, was so anxious to please his boss that he misinterpreted some minor shift in the general's position as a direction to do some foolish thing. The pilot crashed the plane and became a paraplegic.

Well, naturally, cases like this one get the attention of careful thinkers like Boss Buffett, who always acts like an overquiet mouse around his pilots.

Such cases are also given attention in the simulator training of copilots who have to learn to ignore certain really foolish orders from boss pilots because boss pilots will sometimes err disastrously. Even after going through such a training regime, however, copilots in simulator exercises will too often allow the simulated plane to crash because of some extreme and perfectly obvious simulated error of the chief pilot.

After Corporal Hitler had risen to dominate Germany, leading a bunch of believing Lutherans and Catholics into orgies of genocide and other mass destruction, one clever psychology professor, Stanley Milgram, decided to do an experiment to determine exactly how far authority figures could lead ordinary people into gross misbehavior. In this experiment, a man posing as an authority figure, namely a professor governing a respectable experiment, was able to trick a great many ordinary people into giving what they had every reason to believe were massive electric shocks that inflicted heavy torture on innocent fellow citizens. This experiment did demonstrate a terrible result contributed to by Authority-Misinfluence Tendency, but it also demon-

strated extreme ignorance in the psychology professoriate right after World War II.

Almost any intelligent person with my checklist of psychological tendencies in his hand would, by simply going down the checklist, have seen that Milgram's experiment involved about six powerful psychological tendencies acting in confluence to bring about his extreme experimental result. For instance, the person pushing Milgram's shock lever was given much social proof from presence of inactive bystanders whose silence communicated that his behavior was okay. Yet it took over a thousand psychological papers, published before I got to Milgram, for the professoriate to get his experiment only about ninety percent as well understood as it would have immediately been by any intelligent person who used (1) any sensible organization of psychology along the lines of this talk, plus (2) a checklist procedure. This outcome displaying the dysfunctional thinking of long-dead professors deserves a better explanation. I will later deal with the subject in a very hesitant fashion.

We can be pleased that the psychology professoriate of a former era wasn't quite as dysfunctional as the angler in my next-to-last illustration of Authority-Misinfluence Tendency.

When I once fished in the Rio Colorado in Costa Rica, my guide, in a state of shock, told me a story about an angler who'd earlier come to the river without ever having fished for tarpon. A fishing guide like the one I had runs the boat and gives fishing advice, establishing himself in this context as the ultimate authority figure. In the case of this guide, his native language was Spanish, while the angler's native language was English. The angler got a big tarpon on and began submitting to many directions from this authority figure called guide: tip up, tip down, reel in, etc. Finally, when it was necessary to put more pressure on the fish by causing more bending of the angler's rod, the guide said in English: "Give him the rod, give him the rod." Well, the angler threw his expensive rod at the fish, and when last seen, it was going down the Rio Colorado toward the ocean. This example shows how powerful is the tendency to go along with an authority figure and how it can turn ones brain into mush.

My final example comes from business. A psychology Ph.D. once became a CEO of a major company and went wild, creating an expensive headquarters, with a great wine cellar, at an isolated site. At some point, his underlings remonstrated that money was running short. "Take the money out of the depreciation reserves," said the CEO. Not too easy because a depreciation reserve is a liability account.

So strong is undue respect for authority that this CEO, and many even worse examples, have actually been allowed to remain in control of important business institutions for long periods after it was clear they should be removed. The obvious implication: be careful whom you appoint to power because a dominant authority figure will often be hard to remove, aided as he will be by Authority-Misinfluence Tendency.

23. Twaddle Tendency

Man, as a social animal who has the gift of language, is born to prattle and to pour out twaddle that does much damage when serious work is being attempted. Some people produce copious amounts of twaddle and others very little.

A trouble from the honeybee version of twaddle once demonstrated in an interesting experiment. A honeybee normally goes out and finds nectar and then comes back and does a dance that communicates to the other bees where the nectar is. The other bees then go out and get it. Well some scientist – clever, like B. F. Skinner – decided to see how well a honeybee would do with a handicap. He put the nectar straight up. Way up. Well, in a natural setting, there is no nectar a long way straight up, and the poor honeybee doesn't have a genetic program that is adequate to handle what she now as to communicate. You might guess that this honeybee would come back to the hive and slink into a corner, but she doesn't. She comes into the hive and does an incoherent dance. Well, all my life I've been dealing with the human equivalent of that honeybee. And it's a very important part of wise administration to keep prattling people, pouring out twaddle, far away from the serious work.

A rightly famous Caltech engineering professor, exhibiting more insight than tact, once expressed his version of this idea as follows: "The principal job of an academic administration is to keep the people who don't matter from interfering with the work of the people that do." I include this quotation partly because I long suffered from backlash caused by my version of this professor's conversational manner. After much effort, I was able to improve only slightly, so one of my reasons for supplying the quotation is my hope that, at least in comparison, I will appear tactful.

24. Reason-Respecting Tendency

There is in man, particularly one in an advanced culture, a natural love of accurate cognition and a joy in its exercise. This accounts for the widespread popularity of crossword puzzles, other puzzles, and bridge and chess columns, as well as all games requiring mental skill.

This tendency has an obvious implication. It makes man especially prone to learn well when a would-be teacher gives correct reasons for what is taught, instead of simply laying out the desired belief *ex cathedra* with no reasons given. Few practices, therefore, are wiser than not ouly thinking through reasons before giving orders but also communicating these reasons to the recipient of the order.

No one knew this better than Carl Braun, who designed oil refineries with spectacular skill and integrity.

He had a very simple rule, one of many in his large, Teutonic company: You had to tell Who was to do What, Where, When, and Why. And if you wrote a communication leaving out your explanation of why the addressee was to do what was ordered, Braun was likely to fire you because Braun well knew that ideas got through best when reasons for the ideas were meticulously laid out.

In general, learning is most easily assimilated and used when, life long, people consistently hang their experience, actual and vicarious, on a latticework of theory answering the question: Why? Indeed, the question "Why?" is a sort of Rosetta stone opening up the major potentiality of mental life.

Unfortunately, Reason-Respecting Tendency is so strong that even a person's giving of meaningless or incorrect reasons will increase compliance with his orders and requests. This has been demonstrated in psychology experiments wherein "compliance practitioners" successfully jump to the head of the lines in front of copying machines by explaining their reason: "I have to make some copies." This sort of unfortunate byproduct of Reason-Respecting Tendency is a conditioned reflex, based on a widespread appreciation of the importance of reasons. And, naturally, the practice of laying out various claptrap reasons is much used by commercial and cult "compliance practitioners" to help them get what they don't deserve.

25. Lollapalooza Tendency – The Tendency to Get Extreme Consequences from Confluences of Psychological Tendencies Acting in Favor of a Particular Outcome

This tendency was not in any of the psychology texts I once examined, at least in any coherent fashion, yet it dominates life. It accounts for the extreme result in the Milgram experiment and the extreme success of some cults that have stumbled through practice evolution into bringing pressure from many psychological tendencies to bear at the same time on conversion targets. The targets vary in susceptibility, like the dogs Pavlov worked with in his old age, but some of the minds that are targeted simply snap into zombiedom under cult pressure. Indeed, that is one cult's name for the conversion phenomenon: snapping.

What are we to make of the extreme ignorance of the psychology textbook writers of yesteryear? How could anyone who had taken a freshman course in physics or chemistry not be driven to consider, above all, how psychological tendencies combine and with what effects? Why would anyone think his study of psychology was adequate without his having endured the complexity involved in dealing with intertwined psychological tendencies? What could be more ironic than professors using oversimplified notions while studying bad cognitive effects grounded in the mind's tendency to use oversimplified algorithms?

I will make a few tentative suggestions. Maybe many of the long-dead professors wanted to create a whole science from one narrow type of repeatable psychology experiment that was conductible in a university setting and that aimed at one psychological tendency at a time. If so, these early psychology professors made a massive error in so restricting their approach to their subject. It would be like physics ignoring astrophysics because it couldn't happen in a physics lab, plus all compound effects. What psychological tendencies could account for early psychology professors adopting an over-restricted approach to their own subject matter? One candidate would be Availability-Misweighing Tendency grounded in a preference for easy-to-control data. And then the restrictions would eventually create an extreme case of man with a hammer tendency. Another candidate might be Envy/jealousy Tendency through which early psychology professors displayed some weird form of envy of a physics that was misunderstood. And this possibility tends to demonstrate that leaving envy/jealousy out of academic psychology was never a good idea. I now quit claim of all these historical mysteries to my betters.

Well, that ends my brief description of psychological tendencies.

QUESTIONS AND ANSWERS

Now, as promised, I will ask and answer a few general questions.

Q. Isn't this list of psychological tendencies tautological to some extent compared to the system of Euclid? That is, aren't there overlaps in the tendencies? And couldn't the system be laid out just as plausibly in a somewhat different way?

The answers are yes, yes, and yes, but this matters only moderately. Further refinement of these tendencies, while desirable, has a limited practical potential because a significant amount of messiness is unfixable in a soft science like psychology.

Q. Can you supply a real world model, instead of a Milgram-type controlled psychology experiment, that uses your system to illustrate multiple psychological tendencies interacting in a plausibly diagnosable way?

The answer is yes. One of my favorite cases involves the McDonnell Douglas airliner evacuation test. Before a new airliner can be sold, the government requires that it pass an evacuation test, during which a full load of passengers must get out in some short period of time. The government directs that the test be realistic. So you can't pass by evacuating only twenty-year-old athletes. So McDonnell Douglas scheduled such a test in a darkened hangar using a lot of old people as evacuees. The passenger cabin was, say, twenty feet above the concrete floor of the hangar and was to be evacuated through

moderately flimsy rubber chutes. The first test was made in the morning. There were about twenty very serious injuries, and the evacuation took so long it flunked the time test. So what did McDonnell Douglas next do? It repeated the test in the afternoon, and this time there was another failure, with about twenty more serious injuries, including one case of permanent paralysis.

What psychological tendencies contributed to this terrible result? Well, using my, tendency list as a checklist, I come up with the following explanation. Reward-Superresponse Tendency drove McDonnell Douglas to act fast. It couldn't sell its airliner until it passed the test. Also pushing the company was Doubt-Avoidance Tendency with its natural drive to arrive at a decision and run with it. Then the government's direction that the test be realistic drove Authority-Misinfluence Tendency into the mischief of causing McDonnell Douglas to overreact by using what was obviously too dangerous a test method. By now the course of action had been decided, so Inconsistency Avoidance Tendency helped preserve the near idiotic plan. When all the old people got to the dark hangar, with its high airline cabin and concrete floor, the situation must have made McDonnell Douglas employees very queasy, but they saw other employees and supervisors not objecting. Social Proof Tendency, therefore, swamped the queasiness. And this allowed continued action as planned, a continuation that was aided by more Authority Overinfluence Tendency. Then came the disaster of the morning test with its failure, plus serious injuries. McDonnell Douglas ignored the strong disconfirming evidence from the failure of the first test because confirmation bias, aided by the triggering of strong Deprival Superreaction Tendency favored maintaining the original plan. McDonnell Douglas' Deprival Superreaction Tendency was now like that which causes a gambler, bent on getting even after a huge loss, to make his final big bet. After all, McDonnell Douglas was going to lose a lot if it didn't pass its test as scheduled. More psychology-based explanation can probably be made, but the foregoing discussion is complete enough to demonstrate the utility of my system when used in a checklist mode.

Q. In the practical world, what good is the thought system laid out in this list of tendencies? Isn't practical benefit prevented because these psychological tendencies are so thoroughly programmed into the human mind by broad evolution [the combination of genetic and cultural evolution] that we can't get rid of them?

Well, the answer is that the tendencies are probably much more good than bad. Otherwise, they wouldn't be there, working pretty well for man, given his condition and his limited brain capacity. So the tendencies can't be simply washed out automatically, and shouldn't be. Nevertheless, the psychological thought system described, when properly understood and used, enables the spread of wisdom and good conduct and facilitates the avoidance of disaster. Tendency is not always destiny, and knowing the tendencies and their antidotes can often help prevent trouble that would otherwise occur.

Here is a short list of examples reminding us of the great utility of elementary psychological knowledge:

1) Carl Braun's communication practices.
2) The use of simulators in pilot training.
3) The system of Alcoholics Anonymous.
4) Clinical training methods in medical schools.
5) The rules of the U.S. Constitutional Convention: totally secret meetings, no recorded vote by name until the final vote, votes reversible at any time before the end of the convention, then just one vote on the whole Constitution. These are very clever psychology-respecting rules. If the founders had used a different procedure, many people would have been pushed by various psychological tendencies into inconsistent, hardened positions. The elite founders got our Constitution through by a whisker only because they were psychologically acute.
6) The use of Granny's incentive-driven rule to manipulate oneself toward better performance of one's duties.
7) The Harvard Business School's emphasis on decision trees. When I was young and foolish I used to laugh at the Harvard Business School. I said, "They're teaching twenty-eight year-old people that high school algebra works in real life?" But later, I wised up and realized that it was very important that they do that to counter some bad effects from psychological tendencies. Better late than never.
8) The use of autopsy equivalents at Johnson & Johnson. At most corporations, if you make an acquisition and it turns out to be a disaster, all the people, paperwork, and presentations that caused the foolish acquisition are quickly forgotten. Nobody wants to be associated with the poor outcome by mentioning it. But at Johnson & Johnson, the rules make everybody revisit old acquisitions, comparing predictions with outcomes. That is a very smart thing to do.
9) The great example of Charles Darwin as he avoided confirmation bias, which has morphed into the extreme anti-confirmation-bias method of the "double blind" studies wisely required in drug research by the FDA.
10) The Warren Buffett rule for open-outcry auctions: Don't go.

Q. What special knowledge problems lie buried in the thought system demonstrated by your list?

Well, one answer is paradox. In social psychology, the more people learn about the system the less it is true, and this is what gives the system its great value as a preventer of bad outcomes and a driver of good outcomes. This result is paradoxical, and doesn't remind one of elementary physics, but so what. One can't get all the paradox out of pure math, so why should psychology be shocked by some paradox?

There is also some paradox in cognition change that works even when the manipulated person knows he is being manipulated. This creates a sort of paradox in a paradox, but, again, so what. I once much enjoyed an occasion of this sort. I drew this beautiful woman as my dinner partner many years ago. I'd never seen her before. She was married to a prominent Los Angeles man. She sat down next to me, turned her beautiful face up, and said, "Charlie, what one word accounts for your remarkable success in life?" I knew I was being manipulated by a practiced routine, and I just loved it. I never see this woman without a little lift in my spirits. And, by the way, I told her I was rational. You'll have to judge yourself whether that's true. I may be demonstrating some psychological tendency I hadn't planned on demonstrating.

Q. Don't we need more reconciliation of psychology and economics?

My answer is yes, and I suspect that some slight progress is being made. I have heard of one such example. Colin Camerer of Caltech, who works in "experimental economics," devised an interesting experiment in which he caused high I.Q. students, playing for real money, to pay price A+B for a "security" they knew would turn into A dollars at the end of the day. This foolish action occurred because the students were allowed to trade with each other in liquid market for the security. And some students then paid price A+B because they hoped to unload on other students at a higher price before the day was over. What I will now confidently predict is that, despite Camerer's experimental outcome, most economics and corporate finance professors who still believe in the "hard-form efficient market hypothesis" will retain their original belief. If so, this will be one more indication of how irrational smart people can be when influenced by psychological tendencies.

Q. Don't moral and prudential problems come with knowledge of these psychological tendencies?

The answer is yes. For instance, psychological knowledge improves persuasive power and, like other power, it can be used for good or ill. Captain Cook once played a psychology-based trick on his seamen to cause them to eat sauerkraut and avoid scurvy. In my opinion, this action was both ethical and wise under the circumstances, despite the deliberate manipulation involved. But ordinarily, when you try to use your knowledge of psychological tendencies in the artful manipulation of someone whose trust you need, you will be making both a moral and prudential error. The moral error is obvious. The prudential error comes because many intelligent people, targeted for conscious manipulation, are likely to figure out what you are trying to do and resent your action.

Q. Aren't there factual and reasoning errors in this talk?

The answer is yes, almost surely yes. The final revision was made from memory over about fifty hours by a man eighty-one years old, who never took a course in psychology and has read none of it, except one book on developmental psychology, for nearly fifteen years. Even so. I think the totality of my talk will stand up very well, and I hope all my descendants and friends will carefully consider what I have said. I even hope that more psychology professors will join me in:

1) making heavy use of inversion;
2) driving for a complete description of the psychological system so that it works better as a checklist; and
3) especially emphasizing effects from combinations of psychological tendencies.

Well that ends my talk. If in considering what I have said you had ten percent the fun I had saying it, you were lucky recipients.

Selections from three of Charlie Munger's talks, combined into one talk never made, after revisions by Charlie in 2005 that included considerable new material. The three talks were:

(1) The Bray Lecture at the Caltech Faculty Club, February 2, 1992;

(2) Talk under the Sponsorship of the Cambridge Center for Behavioral Studies at the Harvard Faculty Club, October 6, 1994; and the extensive revision by Charlie in 2005, made from memory unassisted by any research, occurred because Charlie thought he could do better at age eighty-one than he did more than ten years earlier when he knew less and was more harried by a crowded life and was speaking from rough notes instead of revising transcripts.

(3) Talk under the Sponsorship of the Cambridge Center for Behavioral Studies at the Boston Harbor Hotel, April 24, 1995.

Charlie Munger - USC Commencement Speech 2007

Well no doubt many of you are wondering why the speaker is so old, well the answer is obviously he hasn't died yet. And why was the speaker chosen? Well I don't know that either. I like to think that the development department had nothing to do with it. Whatever the reason I think it's very fitting that I'm sitting here because I see one crowd of faces in the rear not wearing robes, and I know, from having educated an army of descendants, who really deserves a lot of the honors that are being given are the people here upfront.

The sacrifice and the wisdom and the value transfer that comes from one generation to the next can never be underrated. And that gives me enormous pleasure as I look at this sea of Asian faces to my left. All my life I've admired Confucius. I like the idea of filial piety, the idea that there are values that are taught and duties that come naturally and all that should be passed on to the next generation. And you people who don't think there's anything in this idea, please note how fast these Asian faces are rising in American life. I think they have something.

All right, I scratched out a few notes and I'm going to try and just give an account of some ideas and attitudes that have worked well for me. I don't claim that they are perfect for everybody. Although I think many of them are pretty close to Universal values and many of them are can't fail ideas. What are the core ideas that have helped me?

Well luckily I got at a very early age, the idea that the safest way to try and get what you want, is to try and deserve what you want. It's such a simple idea, it's the golden rule so to speak. You want to deliver to the world what you would buy if you were on the other end. There is no ethos in my opinion, that is better for any lawyer or any other person to have. By and large the people who have this ethos win in life and they don't win just money, just honors, they win the respect, the deserved trust, of the people they deal with, and there is huge pleasure in life to be obtained from getting deserved trust. And so the way to get it is to deliver what you'd want to buy if the circumstances were reversed. Occasionally you find a perfect rogue of a person, who dies rich and widely known. But mostly these people are fully understood by the surrounding civilization, and when the cathedral is full of people at the funeral ceremony, most of them are there to celebrate the fact that the person is dead.

And, that reminds me of the story of the time when one of these people died and the minister said, "it's now time for someone to say something nice about the deceased".

And nobody came forward. And nobody came forward. And nobody came forward. And finally one man came up and he said, “well, his brother was worse”. That is not where you want to go! That’s not the kind of funeral you want to have you'll leave entirely the wrong example.

A second idea that I got very early was that there is no love that’s so right as admiration based love, and that love should include the instructive dead. Somehow I got that idea and I lived with it all my life and it’s been very very useful to me. A love like that celebrated by Somerset Maugham and his book “Of Human Bondage” that’s a sick kind of love, it’s a disease. And if you find yourself in a disease like that my advice to you is turn around and fix it. Eliminate it.

Another idea that I got and this may remind you of Confucius too, is that wisdom acquisition is a moral duty, it’s not something you do just to advance in life. Wisdom acquisition is a moral duty. And there’s a corollary to that proposition which is very important, it means that you’re hooked for lifetime learning, and without lifetime learning you people are not going to do very well. You are not going to get very far in life based on what you already know. You’re going to advance in life by what you’re going to learn after you leave here. If you take Berkshire Hathaway, which is certainly one of the best regarded corporations in the world and may have the best long-term investment record in the entire history of civilization. The skill that got Berkshire through one decade would not have sufficed to get it through the next decade with the achievements made. Without Warren Buffett being a learning machine, a continuous learning machine, the record would have been absolutely impossible. The same is true at lower walks of life. I constantly see people rise in life who are not the smartest, sometimes not even the most diligent, but they are learning machines, they go to bed every night a little wiser than when they got up and boy does that help particularly when you have a long run ahead of you.

Alfred North Whitehead said it one time that “the rapid advance of civilization came only when man invented the method of invention”, and of course he was referring to the huge growth of GDP per capita and all the other good things that we now take for granted which started a few hundred years ago and before that all was stasis. So if civilization can progress only when it invents the method of invention, you can progress only when you learn the method of learning.

I was very lucky. I came to law school having learned the method of learning and nothing has served me better in my long life than continuous learning. And if you take Warren Buffett and watched him with a time clock, I would say half of all the time he

spends is sitting on his ass and reading. And a big chunk of the rest of the time is spent talking one on one either on the telephone or personally with highly gifted people whom he trusts and who trust him. In other words it looks quite academic all this worldly success.

Academia has many wonderful values in it. I came across such a value not too long ago. It was several years ago. In my capacity as a hospital board chairman I was dealing with a medical school academic. And this man over years of hard work had made himself know more about bone tumor pathology than almost anybody else in the world. And he wanted to pass this knowledge on to the rest of us. And how was he going to do it? Well he decided to write a textbook that would be very useful to other people. And I don't think a textbook like this sells two thousand copies if those two thousand copies are in all the major cancer centers in the world. He took a year sabbatical, he sat down in his computer and he had all the slides because he saved them and organized them and filed them. He worked 17 hours a day, 7 days a week, for a year and that was his sabbatical. At the end of the year he had one of the great bone tumor pathology textbooks in the world. When you're around values like that, you want to pick up as much as you can.

Another idea that was hugely useful to me was that I listened in law school when some wag said, "A legal mind is a mind that when two things are all twisted up together and interacting, it's feasible to think responsibly about one thing and not the other." Well I could see from that one sentence that that was perfectly ridiculous, and it pushed me further into my natural drift, which was into learning all the big ideas and all the big disciplines. So I wouldn't be a perfect damn fool who was trying to think about one aspect of something that couldn't be removed from the totality of the situation in a constructive fashion. And what I noted since the really big ideas carry 95% of the load, it wasn't at all hard for me to pick up all the big ideas and all the big disciplines and make them a standard part of my mental routines.

Once you have the ideas of course they are no good if you don't practice. You don't practice you lose it. So I went through life constantly practicing this model of disciplinary approach. Well I can't tell you what that's done for me, it's made life more fun, it's made me more constructive, it's made me more helpful to others, it's made me enormously rich, you name it, that attitude really helps. Now there are dangers there, because it works so well, that if you do it, you will frequently find you are sitting in the presence of some other expert, maybe even an expert that's superior to you, supervising you. And you will know more than he does about his own specialty, a lot more. You will see the correct answer when he's missed it. That is a very dangerous

position to be in. You can cause enormous offense by helpfully being right in a way that causes somebody else to lose face. And I never found a perfect way to solve that problem.

I was a great poker player when I was young but I wasn't a good enough poker player so people failed to sense that I thought I knew more than they did about their subjects and it gave a lot of offense. Now I'm just regarded as eccentric but it was a difficult period to go through. And my advice to you is to learn sometimes to keep your light under a bushel. One of my colleagues, also number one in his class in law school, a great success in life worked for the supreme court etc. He knew a lot and he tended to show it as a very young lawyer and one day the senior partner called him in and said, "listen Chuck, I want to explain something to you. Your duty under any circumstances is to behave in such a way that the client thinks he's the smartest person in the world. If you have any little energy and insight available after that, use it to make your senior partner look like the smartest person in the world. And only after you've satisfied those two obligations do you want your light to shine at all". Well, that may be very good advice for rising in a large firm. It wasn't what I did I always obeyed the drift of my nature and if other people didn't like it I didn't need to be adored by everybody.

Another idea, and by the way when I talk about this multidisciplinary attitude I'm really following a very key idea of the greatest lawyer of antiquity, Marcus Tullius Cicero. Cicero is famous for saying, "a man who doesn't know what happened before he was born goes through life like a child". That is a very correct idea of Cicero's. And he's right to ridicule somebody so foolish as not to know what happened before he was born. But if you generalize Cicero as I think one should, there are all these other things that you should know in addition to history and those other things are the big ideas in all the other disciplines. And it doesn't help you just to know them enough just so you can regurgitate them back on an exam and get an A. You have to learn these things in such a way that they're in a mental latticework in your head and you automatically use them for the rest of your life. If you do that I solemnly promise you that one day you'll be walking down the street and look to your right and left and think, "my heavenly days! I'm now one of the few most competent people of my whole age forward." If you don't do it, many of the brightest of you will live in the middle ranks or in the shallows.

Another idea that I got, and it was encapsulated by that story the Dean recounted about the man who wanted to know where he was going to die and he wouldn't go there, that rustic let that idea have a profound truth in his hand. The way complex

adaptive systems work and the way mental constructs work; problems frequently get easier and I would even say usually are easier to solve if you turn around in reverse. In other words if you want to help India, the question you should ask is not “how can I help India?”, you think “what’s doing the worst damage in India? What would automatically do the worst damage and how do I avoid it?" You’d think they are logically the same thing, they’re not. Those of you who have mastered algebra know that inversion frequently will solve problems which nothing else will solve. And in life, unless you’re more gifted than Einstein, inversion will help you solve problems that you can't solve in other ways.

But to use a little inversion now, what will really fail in life? What do you want to avoid? Such an easy answer; sloth and unreliability. If you’re unreliable it doesn’t matter what your virtues are, you’re going to crater immediately. So doing what you have faithfully engaged to do should be an automatic part of your conduct. You want to avoid sloth and unreliability.

Another thing I think should be avoided is extremely intense ideology because it cabbages up one’s mind. You’ve seen that. You see a lot of it on TV you know preachers for instance, you know they’ve all got different ideas about theology and a lot of them have minds that are made of cabbage. But that can happen with political ideology. And if you're young it’s easy to drift in to loyalties and when you announce that you’re a loyal member and you start shouting the orthodox ideology out what you’re doing is pounding it in, pounding it in and you’re gradually ruining your mind so you want to be very careful with this ideology. It’s a big danger.

In my mind I got a little example I use whenever I think about ideology and it’s these Scandinavian canoeists who succeeded in taming all the rapids of Scandinavia and they thought they would tackle the whirlpools in the Aaron Rapids here in the United States. The death rate was 100%. A big whirlpool is not something you want to go into and I think the same is true about a really deep ideology. I have what I call an iron prescription that helps me keep sane when I naturally drift toward preferring one ideology over another. And that is I say “I’m not entitled to have an opinion on this subject unless I can state the arguments against my position better than the people do who are supporting it. I think only when I reach that stage am I qualified to speak.” Now you can say that’s too much of an iron discipline, it’s not too much of an iron discipline, it’s not even that hard to do. It sounds a lot like the iron prescription of Ferdinand the Great, “it’s not necessary to hope in order to persevere." That probably is too tough for most people, I don’t think it’s too tough for me but it's too tough for most people.

But this business of not drifting into extreme ideology is a very very important thing in life if you want to have more correct knowledge and be wiser than other people. A heavy ideology is very likely to do you in.
Another thing of course that does one in is the self serving bias to which we are all subject. You think that your little me is entitled to do what it wants to do, and for instance why shouldn't the true little me overspend my income? Well, there once was a man who became the most famous composer in the world but he was utterly miserable most of the time and one of the reasons was he always overspent his income, that was Mozart. If Mozart can't get by with this kind of asinine conduct, I don't think you should try it.

Generally speaking, envy, resentment, revenge and self pity are disastrous modes of thought, self-pity gets pretty close to paranoia, and paranoia is one of the very hardest things to reverse, you do not want to drift into self-pity. I have a friend who carried a big stack of linen cards about this thick, and when somebody would make a comment that reflected self pity, he would take out one of the cards, take the top one off the stack and hand it to the person, and the card said, "your story has touched my heart, never have I heard of anyone with as many misfortunes as you". Well you can say that's waggery, but I suggest that every time you find you're drifting into self pity, I don't care what the cause your child could be dying of cancer, self-pity is not going to improve the situation, just give yourself one of those cards. It's a ridiculous way to behave, and when you avoid it you get a great advantage over everybody else, almost everybody else, because self-pity is a standard condition and yet you can train yourself out of it.

And of course a self serving bias, you want to get out of yourself, thinking that what's good for you is good for the wider civilization and rationalizing all these ridiculous conclusions based on the subconscious tendency to serve one's self. It's a terribly inaccurate way to think and of course you want to drive that out of yourself because you want to be wise not foolish. You also have to allow for the self serving bias of everybody else, because most people are not gonna remove it all that successfully, the only condition being what it is. If you don't allow for self serving bias in your conduct, again you're a fool.

I watched the brilliant Harvard law Review trained general counsel lose his career, and what he did was when the CEO was become aware some underling has done something wrong the general counsel said "gee we don't have any legal duty to report this but I think it's what we should do it's our moral duty." Of course the general

counsel was totally correct but of course it didn't work it was a very unpleasant thing for the CEO to do and he put it off and put if off and of course everything erode into a major scandal and down went the CEO and the general counsel with him. The correct answer in situations like that was given by Ben Franklin, he said "if you want to persuade appeal to interest not to reason." The self serving bias is so extreme. If the general counsel said, "look this is going to erupt, it's something that will destroy you take away your money, take away your status it's a perfect disaster", it would have worked! You want to appeal to interest, you want to do it of lofty motives, but you should not avoid appealing to interest.

Another thing, perverse incentives. You don't want to be in a perverse incentive system that's causing you to behave more and more foolishly or worse and worse. Incentives are too powerful a controller of human cognition and human behavior and one of the things you are going to find in some modern law firms is billable hour quotas and I could not have lived under a billable hour quota of 2,400 hours a year. That would have caused serious problems for me I wouldn't have done it and I don't have a solution for you for that you have to figure it out for yourself but it's a significant problem.

Perverse associations, also to be avoided. You particularly want to avoid working directly under somebody you really don't admire and don't want to be like. It's very dangerous we are all subject to control to some extent our authority figures strictly authority figures that are rewarding us. And that requires some talent, the way I solved that is I figured out the people I did admire and I maneuvered cleverly without criticizing anybody so I was working entirely under people I admired. And a lot of law firms will permit that if you're shrewd enough to work it out and your outcome in life will be way more satisfactory and way better if you work under people you really admire, the alternative is not a good idea.

Objectivity maintenance. Well we all remember that Darwin paid special attention to disconfirming evidence particularly to disconfirm something he believed and loved. Well objectivity maintenance routines are totally required in life if you're going to be a correct thinker. And they were talking about Darwin's attitude, special attention to the disconfirming evidence, and also to checklist routines. Checklist routines avoid a lot of errors. You should have all this elementary wisdom and then you should go through and have a checklist in order to use it. There is no other procedure that will work as well.

A last idea that I found very important is I realized very early that non-egality would

work better in the parts of the world I wanted to inhabit. What do I mean by non-egality? I mean John Wood when he was the number one basketball coach in the world, he just said to the bottom five players, “you don’t get to play, you’re sparring partners”, the top seven did the whole playing. Well the top seven learned more, remember the learning machine, because they were doing all the playing. And when he got to that system Wood won more than he’d ever won before.

I think the game of life in many respects is getting a lot of practice into the hands of the people that have the most aptitude to learn and the most tendency to be learning machines. And if you want the very highest reaches of human civilization that’s where you have to go. You do not want to choose a brain surgeon for your child among fifty applicants all of them just take turns during the procedure. You don’t want your airplanes designed that way. You don’t want your Berkshire Hathaway’s run that way. You want to get the power into the right people.

I frequently tell the story of Max Planck when he won the Nobel prize and went around Germany giving lectures on quantum mechanics, and the chauffeur gradually memorized the lecture and he said, “would you mind professor Planck just, it’s so boring staying on our routines, would you mind if I gave the lecture this time and you just sat in front with my chauffeur’s hat?” And Planck said sure. And the chauffeur got up and gave this long lecture on quantum mechanics after which a physics professor stood up in the rear and asked a perfectly ghastly question and the chauffeur said, “well I’m surprised that in an advanced city like Munich I get such an elementary question, I’m going to ask my chauffeur to reply."

Well the reason I tell that story is not entirely to celebrate the quick wittiness of the protagonist. In this world we have two kinds of knowledge, one is Planck knowledge, the people who really know, they paid the dues they have the aptitude. Then we got chauffeur knowledge, they have learned to prattle the talk. They have a big head of hair, they have a fine temper in the voice, they make a hell of an impression, but in the end they've got chauffeur knowledge… I think I’ve just described practically every politician in the United States.

And you are gonna have the problem in your life of getting the responsibility into the people of the Planck knowledge in a way for the people who have the chauffeur knowledge, and there are huge forces working against you. My generation has failed you to some extent. We are delivering to you in California a legislature where only the certified nuts from the left and the certified nuts from the right are allowed to serve

and none of them are removable. That's what my generation has done for you, but you wouldn't like it to be too easy would you?

Another thing that I found is an intense interest of the subject is indispensable if you are really going to excel. I could force myself to be fairly good in a lot of things, but I couldn't be really good in anything where I didn't have an intense interest, so to some extent you're going to have to follow me. If at all feasible you want to drift into doing something in which you really have a natural interest.

Another thing you have to do of course is have a lot of assiduity. I like that word because it means sit down in your ass until you do it. I've had marvelous partners all my life. I think I got them partly because I tried to deserve them and partly because I was wise enough to select them and partly maybe it was some luck. But two partners that I chose for one little phase of my life had the following rule and they created a little designed build, construction team. And they sat down and said, 2 man partnership, divide everything equally, here's the rule; "whenever we're behind in our commitments to other people we will both work 14 hours a day until we caught up." Well needless to say that firm didn't fail! The people died rich. It's such a simple idea.

Another thing of course is life will have terrible blows, horrible blows, unfair blows, doesn't matter. And some people recover and others don't. And there I think the attitude of Epictetus is the best. He thought that every mischance in life was an opportunity to behave well, every mischance in life was an opportunity to learn something and your duty was not to be submerged in self-pity but to utilize the terrible blow in a constructive fashion. That is a very good idea. You may remember the epitaph which Epictetus left for himself, "Here lies Epictetus, a slave maimed in body, the ultimate in poverty, and favored of the gods". Well that's the way Epictetus is now remembered. He said big consequences. And he was favorite of the Gods! He was favored because he became wise, and he became manly. Very good idea.

I got a final little idea because I'm all for prudence as well as opportunism. My grandfather was the only federal judge in his city for nearly forty years and I really admired him. I'm his namesake. And I'm Confucian enough that even now I sit here and I'm saying, "well, Judge Munger would be pleased to see me here." So I'm Confucian enough all these years after my grandfather is dead to carry the torch for my grandfather's values. And grandfather Munger was a federal judge at a time and there were no pensions for widows of federal judges so he didn't save from his income while my grandmother would have been impenured. And being the kind of man he was he underspent his income all his life and left her in comfortable circumstances.

Along the way in the thirties my uncle’s bank failed and couldn’t reopen and my grandfather saved the bank by taking over a third of his assets, good assets, and putting them into the bank and taking up horrible assets in exchange. And of course it did save the bank and while my grandfather took a loss he got most of his money back eventually. But I’ve always remembered the example. And so when I got to college and I came across Houseman, I remember the little poem from Houseman that went something like this:

“The thoughts of others were light and fleeting,
of lovers' meeting Luck or fame.
Mine were of trouble, And mine were steady,
And I was ready When trouble came."

You can say, “who wants to go through life anticipating trouble?”. Well I did! All my life I’ve gone through life anticipating trouble and here I am well along on my 84th year and like Epictetus I’ve had a favored life. It didn't make me unhappy to anticipate trouble all the time and be ready to perform adequately if trouble came. It didn’t hurt me at all. In fact it helped me. So I quick claim to you Houseman and Judge Munger.

The last idea that I want to give you as you go out into a profession that frequently puts a lot of procedure and a lot of precautions and a lot of mumbo jumbo into what it does, this is not a fast form which civilization can reach. A fast form which civilization can reach is a seamless web of deserved trust. Not much procedure just totally reliable people correctly trusting one another. That’s the way an operating room works at the Mayo clinic. If a bunch of lawyers working to introduce a lot of process the patients would all die. So never forget when you’re a lawyer that you may be rewarded for selling this stuff but you don’t have to buy it. In your own life what you want is a seamless web of deserved trust. And if your proposed marriage contract has 47 pages my suggestion is do not enter.

Well that’s enough for one graduation. I hope these ruminations of an old man are useful to you. In the end, I’m like the Old Valiant-for-Truth in The Pilgrim’s Progress; *“My sword I leave to him who can wear it."*

Sacrificing To Restore Market Confidence

By Charles T. Munger

Wednesday, February 11, 2009

Our situation is dire. Moderate booms and busts are inevitable in free-market capitalism. But a boom-bust cycle as gross as the one that caused our present misery is dangerous, and recurrences should be prevented. The country is understandably depressed -- mired in issues involving fiscal stimulus, which is needed, and improvements in bank strength. A key question: Should we opt for even more pain now to gain a better future? For instance, should we create new controls to stamp out much sin and folly and thus dampen future booms? The answer is yes.

Sensible reform cannot avoid causing significant pain, which is worth enduring to gain extra safety and more exemplary conduct. And only when there is strong public revulsion, such as exists today, can legislators minimize the influence of powerful special interests enough to bring about needed revisions in law.

Many contributors to our over-the-top boom, which led to the gross bust, are known. They include insufficient controls over morality and prudence in banks and investment banks; undesirable conduct among investment banks; greatly expanded financial leverage, aided by direct or implied use of government credit; and extreme excess, sometimes amounting to fraud, in the promotion of consumer credit. Unsound accounting was widespread.

There was also great excess in highly leveraged speculation of all kinds. Perhaps real estate speculation did the most damage. But the new trading in derivative contracts involving corporate bonds took the prize. This system, in which completely unrelated entities bet trillions with virtually no regulation, created two things: a gambling facility that mimicked the 1920s "bucket shops" wherein bookie-customer types could bet on security prices, instead of horse races, with almost no one owning any securities, and, second, a large group of entities that had an intense desire that certain companies should fail. Croupier types pushed this system, assisted by academics who should have known better. Unfortunately, they convinced regulators that denizens of our financial system would use the new speculative opportunities without causing more harm than benefit.

Considering the huge profit potential of these activities, it may seem unlikely that any important opposition to reform would come from parties other than conventional, moneyed special interests. But many in academia, too, will resist. It is important that reform plans mix moral and accounting concepts with traditional economic concepts. Many economists take fierce pride in opposing that sort of mixed reasoning. But what these economists like to think about is functionally intertwined, in complex ways, with what they don't like to think about. Those who resist the wider thinking are acting as engineers would if they rounded pi from 3.14 to an even 3 to simplify their calculations. The result is a kind of willful ignorance that fails to understand much that is important.

Moreover, rationality in the current situation requires even more stretch in economic thinking. Public deliberations should include not only private morality and accounting issues but also

issues of public morality, particularly with regard to taxation. The United States has long run large, concurrent trade and fiscal deficits while, to its own great advantage, issuing the main reserve currency of a deeply troubled and deeply interdependent world. That world now faces new risks from an expanding group of nations possessing nuclear weapons. And so the United States may now have a duty similar to the one that, in the danger that followed World War II, caused the Marshall Plan to be approved in a bipartisan consensus and rebuild a devastated Europe.

The consensus was grounded in Secretary of State George Marshall's concept of moral duty, supplemented by prudential considerations. The modern form of this duty would demand at least some increase in conventional taxes or the imposition of some new consumption taxes. In so doing, the needed and cheering economic message, "We will do what it takes," would get a corollary: "and without unacceptably devaluing our money." Surely the more complex message is more responsible, considering that, first, our practices of running twin deficits depend on drawing from reserves of trust that are not infinite and, second, the message of the corollary would not be widely believed unless it was accompanied by some new taxes.

Moreover, increasing taxes in some instances might easily gain bipartisan approval. Surely both political parties can now join in taxing the "carry" part of the compensation of hedge fund managers as if it was more constructively earned in, say, cab driving.

Much has been said and written recently about bipartisanship, and success in a bipartisan approach might provide great advantage here. Indeed, it is conceivable that, if legislation were adopted in a bipartisan way, instead of as a consequence of partisan hatred, the solutions that curbed excess and improved safeguards in our financial system could reduce national pain instead of increasing it. After the failure of so much that was assumed, the public needs a restoration of confidence. And the surest way to gain the confidence of others is to deserve the confidence of others, as Marshall did when he helped cause passage of some of the best legislation ever enacted.

Creating in a bipartisan manner a legislative package that covers many subjects will be difficult. As they work together in the coming weeks, officials might want to consider a precedent that helped establish our republic. The deliberative rules of the Constitutional Convention of 1787 worked wonders in fruitful compromise and eventually produced the U.S. Constitution. With no Marshall figure, trusted by all, amid today's legislators, perhaps the Founding Fathers can once more serve us.

The writer, a Republican, is vice chairman of Berkshire Hathaway Inc., which owns 21 percent of The Washington Post Co.'s common stock.

Basically, It's Over

A parable about how one nation came to financial ruin.

In the early 1700s, Europeans discovered in the Pacific Ocean a large, unpopulated island with a temperate climate, rich in all nature's bounty except coal, oil, and natural gas. Reflecting its lack of civilization, they named this island "Basicland."

The Europeans rapidly repopulated Basicland, creating a new nation. They installed a system of government like that of the early United States. There was much encouragement of trade, and no internal tariff or other impediment to such trade. Property rights were greatly respected and strongly enforced. The banking system was simple. It adapted to a national ethos that sought to provide a sound currency, efficient trade, and ample loans for credit-worthy businesses while strongly discouraging loans to the incompetent or for ordinary daily purchases.

Moreover, almost no debt was used to purchase or carry securities or other investments, including real estate and tangible personal property. The one exception was the widespread presence of secured, high-down-payment, fully amortizing, fixed-rate loans on sound houses, other real estate, vehicles, and appliances, to be used by industrious persons who lived within their means. Speculation in Basicland's security and commodity markets was always rigorously discouraged and remained small. There was no trading in options on securities or in derivatives other than "plain vanilla" commodity contracts cleared through responsible exchanges under laws that greatly limited use of financial leverage.

In its first 150 years, the government of Basicland spent no more than 7 percent of its gross domestic product in providing its citizens with essential services such as fire protection, water, sewage and garbage removal, some education, defense forces, courts, and immigration control. A strong family-oriented culture emphasizing duty to relatives, plus considerable private charity, provided the only social safety net.

The tax system was also simple. In the early years, governmental revenues came almost entirely from import duties, and taxes received matched government expenditures. There was never much debt outstanding in the form of government bonds.

As Adam Smith would have expected, GDP per person grew steadily. Indeed, in the modern area it grew in real terms at 3 percent per year, decade after decade, until Basicland led the world in GDP per person. As this happened, taxes on sales, income, property, and payrolls were introduced. Eventually total taxes, matched by total government expenditures, amounted to 35 percent of GDP. The revenue from increased taxes was spent on more government-run education and a substantial government-run social safety net, including medical care and pensions.

A regular increase in such tax-financed government spending, under systems hard to "game" by the unworthy, was considered a moral imperative—a sort of egality-promoting national dividend—so long as growth of such spending was kept well below the growth rate of the country's GDP per person.

Basicland also sought to avoid trouble through a policy that kept imports and exports in near balance, with each amounting to about 25 percent of GDP. Some citizens were initially nervous because 60 percent of imports consisted of absolutely essential coal and oil. But, as the years rolled by with no terrible consequences from this dependency, such worry melted away.

Basicland was exceptionally creditworthy, with no significant deficit ever allowed. And the present value of large "off-book" promises to provide future medical care and pensions appeared unlikely to cause problems, given Basicland's steady 3 percent growth in GDP per person and restraint in making unfunded promises. Basicland seemed to have a system that would long assure its felicity and long induce other nations to follow its example—thus improving the welfare of all humanity.

But even a country as cautious, sound, and generous as Basicland could come to ruin if it failed to address the dangers that can be caused by the ordinary accidents of life. These dangers were significant by 2012, when the extreme prosperity of Basicland had created a peculiar outcome: As their affluence and leisure time grew, Basicland's citizens more and more whiled away their time in the excitement of casino gambling. Most casino revenue now came from bets on security prices under a system used in the 1920s in the United States and called "the bucket shop system."

The winnings of the casinos eventually amounted to 25 percent of Basicland's GDP, while 22 percent of all employee earnings in Basicland were paid to persons employed by the casinos (many of whom were engineers needed elsewhere). So much time was spent at casinos that it amounted to an average of five hours per day for every citizen of Basicland, including newborn babies and the comatose elderly. Many of the gamblers were highly talented engineers attracted partly by casino poker but mostly by bets available in the bucket shop systems, with the bets now called "financial derivatives."

Many people, particularly foreigners with savings to invest, regarded this situation as disgraceful. After all, they reasoned, it was just common sense for lenders to avoid gambling addicts. As a result, almost all foreigners avoided holding Basicland's currency or owning its bonds. They feared big trouble if the gambling-addicted citizens of Basicland were suddenly faced with hardship.

And then came the twin shocks. Hydrocarbon prices rose to new highs. And in Basicland's export markets there was a dramatic increase in low-cost competition from developing countries. It was soon obvious that the same exports that had formerly amounted to 25 percent of Basicland's GDP would now only amount to 10 percent. Meanwhile, hydrocarbon imports would amount to 30 percent of GDP, instead of 15 percent. Suddenly Basicland had to come up with 30 percent of its GDP every year, in foreign currency, to pay its creditors.

How was Basicland to adjust to this brutal new reality? This problem so stumped Basicland's politicians that they asked for advice from Benfranklin Leekwanyou Vokker, an old man who was considered so virtuous and wise that he was often called the "Good Father." Such consultations were rare. Politicians usually ignored the Good Father because he made no campaign contributions.

Among the suggestions of the Good Father were the following. First, he suggested that Basicland change its laws. It should strongly discourage casino gambling, partly through a complete ban on the trading in financial derivatives, and it should encourage former casino employees—and former casino patrons—to produce and sell items that foreigners were willing to buy. Second, as this change was sure to be painful, he suggested that Basicland's citizens cheerfully embrace their fate. After all, he observed, a man diagnosed with lung cancer is willing to quit smoking and undergo surgery because it is likely to prolong his life.

The views of the Good Father drew some approval, mostly from people who admired the fiscal virtue of the Romans during the Punic Wars. But others, including many of Basicland's prominent economists, had strong objections. These economists had intense faith that any outcome at all in a free market—even wild growth in casino gambling—is constructive. Indeed, these economists were so committed to their basic faith that they looked forward to the day when Basicland would expand real securities trading, as a percentage of securities outstanding, by a factor of 100, so that it could match the speculation level present in the United States just before onslaught of the Great Recession that began in 2008.

The strong faith of these Basicland economists in the beneficence of hypergambling in both securities and financial derivatives stemmed from their utter rejection of the ideas of the great and long-dead economist who had known the most about hyperspeculation, John Maynard Keynes. Keynes had famously said, "When the capital development of a country is the byproduct of the operations of a casino, the job is likely to be ill done." It was easy for these economists to dismiss such a sentence because securities had been so long associated with respectable wealth, and financial derivatives seemed so similar to securities.

Basicland's investment and commercial bankers were hostile to change. Like the objecting economists, the bankers wanted change exactly opposite to change wanted by the Good Father. Such bankers provided constructive services to Basicland. But they had only moderate earnings, which they deeply resented because Basicland's casinos—which provided no such constructive services—reported immoderate earnings from their bucket-shop systems. Moreover, foreign investment bankers had also reported immoderate earnings after building their own bucket-shop systems—and carefully obscuring this fact with ingenious twaddle, including claims that rational risk-management systems were in place, supervised by perfect regulators. Naturally, the ambitious Basicland bankers desired to prosper like the foreign bankers. And so they came to believe that the Good Father lacked any understanding of important and eternal causes of human progress that the bankers were trying to serve by creating more bucket shops in Basicland.

Of course, the most effective political opposition to change came from the gambling casinos themselves. This was not surprising, as at least one casino was located in each legislative district. The casinos resented being compared with cancer when they saw themselves as part of a long-established industry that provided harmless pleasure while improving the thinking skills of its customers.

As it worked out, the politicians ignored the Good Father one more time, and the Basicland banks were allowed to open bucket shops and to finance the purchase and carry of real securities with

extreme financial leverage. A couple of economic messes followed, during which every constituency tried to avoid hardship by deflecting it to others. Much counterproductive governmental action was taken, and the country's credit was reduced to tatters. Basicland is now under new management, using a new governmental system. It also has a new nickname: Sorrowland.

Wantmore, Tweakmore, Totalscum, and the Tragedy of Boneheadia

A Parody about the Great Recession.

By Charles Munger

Posted Wednesday, July 6, 2011, at 4:57 PM ET

A Parody Describing the Contributions of Wantmore, Tweakmore, Totalscum, Countwrong, and Oblivious to the Tragic "Great Recession" in Boneheadia and the Thoughts of Some People Relating to This Disaster.

In the country of Boneheadia there was a man, Wantmore, who earned his income as a home mortgage loan originator. Wantmore operated conservatively. All his home loans bore interest rates of 6 percent or less, and he demanded of all borrowers large down payments, documented proof of adequate income, and an immaculate credit-using history. Wantmore sold all his loans to life insurance companies that, before closing purchases, checked loan quality with rigor—then held all loans to maturity.

As Wantmore prospered, he eventually attracted the attention of Tweakmore, a very bold and ingenious investment banker. There was no other investment banker quite like Tweakmore, even in the United States.

Tweakmore had become the richest person in Boneheadia, driven by an insight that had come to him when, as a college student, he had visited a collection of hotels that contained gambling casinos located in a desert.

As Tweakmore saw immense amounts of cash pouring into cashiers' cages surrounded by endless sand, in business operations that did not tie up any capital in inventories, receivables, or manufacturing equipment, he realized immediately that he was looking at the best business model in the world, provided one could also eliminate commitment of any capital or expense to hotel rooms, restaurants, or facilities providing parking or entertainment.

Tweakmore also saw exactly how he could create for himself an operation that possessed all the characteristics of his ideal business. All he had to do was add to investment banking a lot of activities that were the functional equivalent of casino gambling, with the bank having the traditional "house advantage." Such casino-type activities, masked by respectable-sounding labels, Tweakmore foresaw, could easily grow to dwarf all the action in ordinary casinos.

Determined to create and own his ideal business as fast as possible, Tweakmore quit college and entered investment banking. Within 12 years, Tweakmore was the most important investment banker in Boneheadia. Tweakmore rose so rapidly because he was very successful in convincing regulators and legislators to enlarge what was permissible.

Indeed, by the time Tweakmore called on Wantmore, any investment bank in Boneheadia could invent and trade in any bets it wished, provided they were called "derivatives," designed to make counterparties feel better about total financial risks in their lives, outcomes that automatically happened. Moreover, an investment bank faced no limit on the amount of financial leverage it employed in trading or investing in derivatives or anything else. Also, Tweakmore had obtained permission to use "Mark-To-Model" accounting that enabled each bank to report in its derivative book whatever profit it desired to report. As a result, almost every investment bank claimed ever-growing profits and had ownership of assets totaling at least 30 times an ever-swelling reported net worth. And despite a vast expansion of transaction-clearance risk, no big mess had so far occurred.

Tweakmore was pleased, but not satisfied, by what he had accomplished. And he now planned to revolutionize Boneheadia's home-mortgage loan business in a manner that would make Tweakmore a national hero.

In his first proposal to Wantmore, Tweakmore held much of his ingenuity in reserve. All he proposed was that Wantmore hereafter sell all his home loans to Tweakmore at a higher price than life insurers would pay. Tweakmore said that he planned to put all loans into trusts with no other assets. Each trust would be divided into five "tranches" with different priorities in use of loan payments. Four tranches would use their shares of loan payments to pay off complex new fixed-interest-bearing, freely tradable debt instruments, called CDOs. The fifth tranche got a tiny residue in case all home loan payments were received as due. The CDOs would be sold by Tweakmore, using a highly paid sales force, to anyone who could be induced to buy, even highly leveraged speculators and small Scandinavian cities near the Arctic.

To Wantmore, Tweakmore's proposal at first appeared unfeasible. The planned operation seemed to resemble the operation of a meat vendor who routinely bought 1,000 pounds of chuck roast, sliced it up, and then sold 950 pounds as filet mignon and the balance as dog food.

But Wantmore's doubts melted away when Tweakmore revealed how much he would pay. Under the offered terms, Wantmore would double his income, something Tweakmore could easily afford because his own income was going to be three times that of Wantmore. After Wantmore accepted Tweakmore's proposal, everything worked out exactly as Tweakmore had planned, because buyers of CDOs in aggregate paid much more than the life insurers had formerly paid.

Even so, Wantmore, as he became familiar with Tweakmore's prosperity, was soon dissatisfied with a merely doubled income. With Wantmore restive, Tweakmore now displayed the full range of his ingenuity.

What Tweakmore next proposed was that Wantmore add to his product line a new class of "Subprime, pay-what-you-wish" home-mortgage loans. All loans would bear interest at 7½ percent or more, and borrowers would not be allowed to state anything except that they wanted the money. There would be no down payments and no credit checks or the like. Also, each loan would be very user-friendly in its first three years, during which the borrower could make only tiny payments with all unpaid interest being added to principal. After three years, very onerous loan service was required, designed to pay off the greatly swollen principal, plus all interest, over the next five years.

This proposal would have seemed preposterous, even hilariously satirical, if it had been presented to Wantmore when Tweakmore had first called. But by now Wantmore had doubled his income by going along with a peculiar idea of Tweakmore's. So Wantmore's credulity was easily stretched to allow acceptance of the new loan product, which Tweakmore projected would triple Wantmore's already doubled income.

It is easy to see why Wantmore became a "true believer" in the new loan product. But why did the already super-rich, prominent, and sophisticated Tweakmore believe his revised scheme would work safely and well for him?

Well, we know the answer. As Tweakmore revealed in his prideful autobiography, his thought process was as follows:

1. There would be no significant troubles during the first three years. Under the accounting standards of Boneheadia, all its accountants would be required for a long time to reserve no loan-loss provision at all against unpaid principal and unpaid interest on the new loans. And CDOs would be valued highly in traditional markets because underlying loans were booked at unreasonably high value. It wouldn't matter that homebuyers were making no down payments, had no personal liability at any time, and paid only a tiny portion of interest accrued for three years. It also wouldn't matter that any competent inquiry would have revealed extreme past improvidence on the part of most borrowers.
2. House prices in Boneheadia would not merely rise as they had done before. Prices would rise much faster as more and more people learned they could bid to acquire homes without using any of their own money, no matter how poor were their credit-using histories.
3. All the buyers of new CDOs would have a near-perfect investment experience. Ever-rising house prices would cause full payment of all mortgage debt as due. The market for the new CDOs would expand and expand as investors reliably earned much more and faster as the scheme fed on itself in a runaway feedback mode.
4. True, after the first three years many overstretched homebuyers were sure to suffer somewhat as they were forced, by threats of foreclosure, to sell their homes. This would often cost them their credit and the respect of their children, friends, and employers, but

that would be the only trouble, and it would prove endurable by Tweakmore and everyone else, except the people forced out of their homes.

5. The runaway feedback mode that drove up house prices would cause no significant trouble for decades, as had happened in Japan, where a big bust in real estate prices occurred only after the Imperial Palace grounds in Tokyo were apparently worth more than the market value of the entire state of California.
6. The principles of economics would give the scheme a large tailwind and considerable popularity. As Tweakmore, a former student in elementary economics, knew from studying Galbraith, a large undisclosed embezzlement strongly stimulates spending because the perpetrator is much richer and the victim spends as before because he does not yet feel poorer. And what Tweakmore was creating was the functional equivalent of a long-running undisclosed embezzlement on steroids. The perpetrators would not be the only ones to spend more, as typically occurs during ordinary embezzlements. The CDO-buying victims also would spend more as they believed they were getting richer and richer from ever-growing paper gains embodied in accrual of interest at above normal rates.
7. To be sure, the scheme looked a little like a chain-letter scheme, and such schemes were usually ill-regarded by prospective users, partly because the schemes were criminal and partly because the schemes always blew up so quickly, bringing criminal troubles so soon. Tweakmore's scheme, in contrast, would, by design, be lawful and benevolent, and recognized as such, because it would create big macroeconomic stimulus as a public good.
8. And should the scheme eventually blow up after decades, like the land-price bubble in Japan, who could fairly blame Tweakmore? Nothing lasts forever. Besides, the blowup might be lost in a miasma of other blowups like those sure to come in many irresponsible countries and subdivisions of countries.

Tweakmore's revised scheme worked fantastically well for a considerable period. Naturally, there were some glitches, but Tweakmore turned each glitch into an opportunity to boost profit. For instance, when Wantmore was made nervous as hordes of scumball-salesmen were drawn into his business by rich commissions paid for production of easy-to-sell "subprime" pay-what-you-wish home loans, Tweakmore responded by buying Wantmore's business. Then Tweakmore replaced Wantmore with a new CEO, Totalscum, who did not consider any business practice optimal unless it was depraved. Totalscum soon increased loan production by 400 percent and his success caused Tweakmore to buy five additional loan businesses and replace their CEOs with people like Totalscum, causing profits to soar and soar, even though Tweakmore never again found anyone else whose depraved operations could produce results that matched those of Totalscum.

As Tweakmore's scheme went on, it was necessary for its continuing success that the accountants of Boneheadia never stop treating as trustworthy a lot of hugely important loan-payment promises that any sensible person would deem unreliable. However, there was almost no risk that accountants would act otherwise than as Tweakmore desired. The accountants of Boneheadia were not allowed to be sensible. They had to use rote "rules-based" accounting standards set by a dominating man, Countwrong, who was head of Boneheadia's Accounting Standards Setting Board. And Countwrong had ordained, in effect, that all loss provisions on the new loans must

remain based on the zero-loss record that had existed before Wantmore met Tweakmore. And, so long as Countwrong was in charge, no one was going to use in accounting an understanding of runaway feedback modes, instead of Countwrong's rules.

Of course, if Totalscum or Tweakmore ever started to have loan losses, he would have to start making loan-loss provisions against new loans. But there weren't any meaningful loan losses for anyone for a very long time.

Countwrong was so habit-bound as a thinker that he never recognized that his cognition was anti-social. He had always sought simplicity of process for accountants at the expense of "principles-based" rigor and thought that would better serve his country. He had been rewarded in his life for his convictions, and he was now proud of his conclusions, even as they were contributing mightily to the super-catastrophe sure to come eventually from Tweakmore's scheme.

A large economic boom occurred in Boneheadia just as Tweakmore had expected. The boom made the regulators of Boneheadia feel extremely good about themselves as they passively watched the ever-enlarging operations of Tweakmore and Totalscum.

A famous regulator named Oblivious was particularly approving. He had been over-influenced in early life by classical economics. So influenced, Oblivious loved all the new derivatives, even those based on outcomes of parts of complex CDOs composed of parts of other complex CDOs. And he did not believe the government should rein in any investment banker until the banker's behavior was very much worse than Tweakmore's.

The boom initiated by Tweakmore lasted only three years. He had underestimated the boom's strength and the power of people to understand, in due course, super-sized folly. These factors had helped shorten the boom's duration. Also, Boneheadia had proved less like Japan than had been hoped.

When the boom-ending bust came, it was a doozy. Almost every investment bank had been made collapse-prone by Tweakmore's innovations before he became interested in home loans. And now, in a huge bust, most big financial institutions were sure to disappear, causing total chaos and another "Great Depression" unless there was super-massive intervention by the government, financed by printing money.

Fortunately, Boneheadia did so intervene, guided by effective leaders who somehow obtained support from politicians in both political parties. And, after this massive intervention, Boneheadia, with doubled unemployment, is enormously worse off than if the boom and bust had never happened. And its options in case of future trouble are greatly reduced because, after its money-printing spree, it is nearer to facing general distrust of its money and credit.

Boneheadia's bust is now called the "Great Recession." Yet, even so, not much has been learned by the elite in Boneheadia. Among the protagonists and too-passive types who contributed so much to the mess, only one has expressed significant contrition. To his great credit, Oblivious has recognized that he was grossly wrong.

The accounting profession remains unaware of its large contribution to public woe. And it does not recognize the cognitive defects of Countwrong, which are still believed to be virtuous qualities that reduce accountants' litigation risks and their duty to cause antagonism by opposing the wishes of some of their best-paying clients.

The professoriate in economics has barely budged toward recognition of the importance of optimized, more conservative accounting in both macroeconomics and microeconomics. And economics professors, even now, do not recognize what was so easily recognized by Tweakmore: The functional equivalent of undisclosed embezzlement can be magnified and have massive macroeconomic consequences when the victims, as well as the perpetrators are led to believe they are getting richer under conditions that are going to last for a long time.

How about the legislators in Boneheadia? Well, most are confused by what has happened to their most powerful friends and draw no useful implications from the outcome of Canadia, a country just north of Boneheadia that had no "Great Recession" because its simple laws and regulations kept in place home loan operations much like those of Wantmore before he embraced modern finance in the state preferred by Tweakmore.

How about the regulators? Well, very few important regulators or former regulators in all Boneheadia have expressed really serious doubts about the status quo and interest in really serious re-regulation of investment banking. One the doubters is Follyseer, a long-retired former minister of finance. Follyseer has argued that all contributions of Tweakmore to investment banking should be removed and banned, because it is now obvious that (1) augmenting casino-type activities in investment banks was never a good idea, and (2) investment banks are less likely to cause vast public damage when they are forbidden to use much financial leverage and are limited to few long-traditional activities.

Regarding accounting, no regulator now in power seems to understand, in a way that has any chance of causing effective remedial action, that the disaster triggered by Tweakmore couldn't have happened if Boneheadia's system of accounting regulation had been more "principles-based," with a different and less tradition-bound group creating accounting standards that were less easy to game.

The former regulator and lifelong professor who seemed extra wise after the Great Recession was England's John Maynard Keynes, dead for more than half a century. Keynes had predicted, correctly, that "When the capital development of a country is a by-product of the operations of a casino, the job is likely to be ill-done."

Afterword*: The foregoing attempt is* not *an attempt to describe in a fair way real contributions to the "Great Recession" in the United States. Certain characters and industries, for instance, Tweakmore and investment banking, are grossly overdrawn as contributors to sin and mayhem, while other contributors are not discussed at all. The whole idea was to draw attention to certain issues in accounting, academic economics, and conceivable over-development of finance as a percentage of the entire economy, by making the characters and the story line extreme enough to be memorable.*

Vice Chairman's Thoughts – Past and Future

To the shareholders of Berkshire Hathaway Inc.:

I closely watched the 50-year history of Berkshire's uncommon success under Warren Buffett. And it now seems appropriate that I independently supplement whatever celebratory comment comes from him. I will try to do five things.

(1) Describe the management system and policies that caused a small and unfixably-doomed commodity textile business to morph into the mighty Berkshire that now exists,

(2) Explain how the management system and policies came into being,

(3) Explain, to some extent, why Berkshire did so well,

(4) Predict whether abnormally good results would continue if Buffett were soon to depart, and

(5) Consider whether Berkshire's great results over the last 50 years have implications that may prove useful elsewhere.

The management system and policies of Berkshire under Buffett (herein together called "the Berkshire system") were fixed early and are described below:

(1) Berkshire would be a diffuse conglomerate, averse only to activities about which it could not make useful predictions.
(2) Its top company would do almost all business through separately incorporated subsidiaries whose CEOs would operate with very extreme autonomy.
(3) There would be almost nothing at conglomerate headquarters except a tiny office suite containing a Chairman, a CFO, and a few assistants who mostly helped the CFO with auditing, internal control, etc.
(4) Berkshire subsidiaries would always prominently include casualty insurers. Those insurers as a group would be expected to produce, in due course, dependable underwriting gains while also producing substantial "float" (from unpaid insurance liabilities) for investment.
(5) There would be no significant system-wide personnel system, stock option system, other incentive system, retirement system, or the like, because the subsidiaries would have their own systems, often different.
(6) Berkshire's Chairman would reserve only a few activities for himself.

(i) He would manage almost all security investments, with these normally residing in Berkshire's casualty insurers.

(ii) He would choose all CEOs of important subsidiaries, and he would fix their compensation and obtain from each a private recommendation for a successor in case one was suddenly needed.

(iii) He would deploy most cash not needed in subsidiaries after they had increased their competitive advantage, with the ideal deployment being the use of that cash to acquire new subsidiaries.

(iv) He would make himself promptly available for almost any contact wanted by any subsidiary's CEO, and he would require almost no additional contact.

(v) He would write a long, logical, and useful letter for inclusion in his annual report, designed as he would wish it to be if he were only a passive shareholder, and he would be available for hours of answering questions at annual shareholders' meetings.

(vi) He would try to be an exemplar in a culture that would work well for customers, shareholders, and other incumbents for a long time, both before and after his departure.

(vii) His first priority would be reservation of much time for quiet reading and thinking, particularly that which might advance his determined learning, no matter how old he became; and

(viii) He would also spend much time in enthusiastically admiring what others were accomplishing.

(7) New subsidiaries would usually be bought with cash, not newly issued stock.

(8) Berkshire would not pay dividends so long as more than one dollar of market value for shareholders was being created by each dollar of retained earnings.

(9) In buying a new subsidiary, Berkshire would seek to pay a fair price for a good business that the Chairman could pretty well understand. Berkshire would also want a good CEO in place, one expected to remain for a long time and to manage well without need for help from headquarters.

(10) In choosing CEOs of subsidiaries, Berkshire would try to secure trustworthiness, skill, energy, and love for the business and circumstances the CEO was in.

(11) As an important matter of preferred conduct, Berkshire would almost never sell a subsidiary.

(12) Berkshire would almost never transfer a subsidiary's CEO to another unrelated subsidiary.

(13) Berkshire would never force the CEO of a subsidiary to retire on account of mere age.

(14) Berkshire would have little debt outstanding as it tried to maintain (i) virtually perfect creditworthiness under all conditions and (ii) easy availability of cash and credit for deployment in times presenting unusual opportunities.

(15) Berkshire would always be user-friendly to a prospective seller of a large business. An offer of such a business would get prompt attention. No one but the Chairman and one or two others at Berkshire would ever know about the offer if it did not lead to a transaction. And they would never tell outsiders about it.

Both the elements of the Berkshire system and their collected size are quite unusual. No other large corporation I know of has half of such elements in place.

How did Berkshire happen to get a corporate personality so different from the norm?

Well, Buffett, even when only 34 years old, controlled about 45% of Berkshire's shares and was completely trusted by all the other big shareholders. He could install whatever system he wanted. And he did so, creating the Berkshire system.

Almost every element was chosen because Buffett believed that, under him, it would help maximize Berkshire's achievement. He was not trying to create a one-type-fits-all system for other corporations. Indeed, Berkshire's subsidiaries were not required to use the Berkshire system in their own operations. And some flourished while using different systems.

What was Buffett aiming at as he designed the Berkshire system?

Well, over the years I diagnosed several important themes:

(1) He particularly wanted continuous maximization of the rationality, skills, and devotion of the most important people in the system, starting with himself.
(2) He wanted win/win results everywhere--in gaining loyalty by giving it, for instance.
(3) He wanted decisions that maximized long-term results, seeking these from decision makers who usually stayed long enough in place to bear the consequences of decisions.
(4) He wanted to minimize the bad effects that would almost inevitably come from a large bureaucracy at headquarters.
(5) He wanted to personally contribute, like Professor Ben Graham, to the spread of wisdom attained.

When Buffett developed the Berkshire system, did he foresee all the benefits that followed? No. Buffett stumbled into some benefits through practice evolution. But, when he saw useful consequences, he strengthened their causes.

Why did Berkshire under Buffett do so well?

Only four large factors occur to me:

(1) The constructive peculiarities of Buffett,
(2) The constructive peculiarities of the Berkshire system,
(3) Good luck, and
(4) The weirdly intense, contagious devotion of some shareholders and other admirers, including some in the press.

I believe all four factors were present and helpful. But the heavy freight was carried by the constructive peculiarities, the weird devotion, and their interactions.

In particular, Buffett's decision to limit his activities to a few kinds and to maximize his attention to them, and to keep doing so for 50 years, was a lollapalooza. Buffett succeeded for the same reason Roger Federer became good at tennis.

Buffett was, in effect, using the winning method of the famous basketball coach, John Wooden, who won most regularly after he had learned to assign virtually all playing time to his seven best players. That way, opponents always faced his best players, instead of his second best. And, with the extra playing time, the best players improved more than was normal.

And Buffett much out-Woodened Wooden, because in his case the exercise of skill was concentrated in one person, not seven, and his skill improved and improved as he got older and older during 50 years, instead of deteriorating like the skill of a basketball player does.

Moreover, by concentrating so much power and authority in the often-long-serving CEOs of important subsidiaries, Buffett was also creating strong Wooden-type effects there. And such effects enhanced the skills of the CEOs and the achievements of the subsidiaries.

Then, as the Berkshire system bestowed much-desired autonomy on many subsidiaries and their CEOs, and Berkshire became successful and well known, these outcomes attracted both more and better subsidiaries into Berkshire, and better CEOs as well.

And the better subsidiaries and CEOs then required less attention from headquarters, creating what is often called a "virtuous circle."

How well did it work out for Berkshire to always include casualty insurers as important subsidiaries?

Marvelously well. Berkshire's ambitions were unreasonably extreme and, even so, it got what it wanted.

Casualty insurers often invest in common stocks with a value amounting roughly to their shareholders' equity, as did Berkshire's insurance subsidiaries. And the S&P 500 Index produced about 10% per annum, pre-tax, during the last 50 years, creating a significant tailwind.

And, in the early decades of the Buffett era, common stocks within Berkshire's insurance subsidiaries greatly outperformed the index, exactly as Buffett expected. And, later, when both the large size of Berkshire's stockholdings and income tax considerations caused the index-beating part of returns to fade to insignificance (perhaps not forever), other and better advantage came. Ajit Jain created out of nothing an immense reinsurance business that produced both a huge "float" and a large underwriting gain. And all of GEICO came into Berkshire, followed by a quadrupling of GEICO's market share. And the rest of Berkshire's insurance operations hugely improved, largely by dint of reputational advantage, underwriting discipline, finding and staying within good niches, and recruiting and holding outstanding people.

Then, later, as Berkshire's nearly unique and quite dependable corporate personality and large size became well known, its insurance subsidiaries got and seized many attractive opportunities, not available to others, to buy privately issued securities. Most of these securities had fixed maturities and produced outstanding results.

Berkshire's marvelous outcome in insurance was not a natural result. Ordinarily, a casualty insurance business is a producer of mediocre results, even when very well managed. And such results are of little use. Berkshire's better outcome was so astoundingly large that I believe that Buffett would now fail to recreate it if he returned to a small base while retaining his smarts and regaining his youth.

Did Berkshire suffer from being a diffuse conglomerate? No, its opportunities were usefully enlarged by a widened area for operation. And bad effects, common elsewhere, were prevented by Buffett's skills.

Why did Berkshire prefer to buy companies with cash, instead of its own stock? Well, it was hard to get anything in exchange for Berkshire stock that was as valuable as what was given up.

Why did Berkshire's acquisition of companies outside the insurance business work out so well for Berkshire shareholders when the normal result in such acquisitions is bad for shareholders of the acquirer?

Well, Berkshire, by design, had methodological advantages to supplement its better opportunities. It never had the equivalent of a "department of acquisitions" under pressure to buy. And it never relied on advice from "helpers" sure to be prejudiced in favor of transactions. And Buffett held self-delusion at bay as he underclaimed expertise while he knew better than most corporate executives what worked and what didn't in business, aided by his long experience as a passive investor. And, finally, even when Berkshire was getting much better opportunities than most others, Buffett often displayed almost inhuman patience and seldom bought. For instance, during his first ten years in control of Berkshire, Buffett saw one business (textiles) move close to death and two new businesses come in, for a net gain of one.

What were the big mistakes made by Berkshire under Buffett? Well, while mistakes of commission were common, almost all huge errors were in not making a purchase, including not purchasing Walmart stock when that was sure to work out enormously well. The errors of omission were of much importance. Berkshire's net worth would now be at least $50 billion higher if it had seized several opportunities it was not quite smart enough to recognize as virtually sure things.

The next to last task on my list was: Predict whether abnormally good results would continue at Berkshire if Buffett were soon to depart.

The answer is yes. Berkshire has in place in its subsidiaries much business momentum grounded in much durable competitive advantage.

Moreover, its railroad and utility subsidiaries now provide much desirable opportunity to invest large sums in new fixed assets. And many subsidiaries are now engaged in making wise "bolt-on" acquisitions.

Provided that most of the Berkshire system remains in place, the combined momentum and opportunity now present is so great that Berkshire would almost surely remain a better-than-normal company for a very long time even if (1) Buffett left tomorrow, (2) his successors were persons of only moderate ability, and (3) Berkshire never again purchased a large business.

But, under this Buffett-soon-leaves assumption, his successors would not be "of only moderate ability." For instance, Ajit Jain and Greg Abel are proven performers who would probably be under-described as "world-class." "World-leading" would be the description I would choose. In some important ways, each is a better business executive than Buffett.

And I believe neither Jain nor Abel would (1) leave Berkshire, no matter what someone else offered or (2) desire much change in the Berkshire system.

Nor do I think that desirable purchases of new businesses would end with Buffett's departure. With Berkshire now so large and the age of activism upon us, I think some desirable acquisition opportunities will come and that Berkshire's $60 billion in cash will constructively decrease.

My final task was to consider whether Berkshire's great results over the last 50 years have implications that may prove useful elsewhere.

The answer is plainly yes. In its early Buffett years, Berkshire had a big task ahead: turning a tiny stash into a large and useful company. And it solved that problem by avoiding bureaucracy and relying much on one thoughtful leader for a long, long time as he kept improving and brought in more people like himself.

Compare this to a typical big-corporation system with much bureaucracy at headquarters and a long succession of CEOs who come in at about age 59, pause little thereafter for quiet thought, and are soon forced out by a fixed retirement age.

I believe that versions of the Berkshire system should be tried more often elsewhere and that the worst attributes of bureaucracy should much more often be treated like the cancers they so much resemble. A good example of bureaucracy fixing was created by George Marshall when he helped win World War II by getting from Congress the right to ignore seniority in choosing generals.

Sincerely,

Charles T. Munger