

Berkshire Hathaway Annual Shareholders Meeting notes

The following summary includes references to many of the comments made at the May 5, 2007 Berkshire Hathaway annual meeting of shareholders that were of interest to Dynamic Funds' portfolio managers in attendance. The notes are in no particular order and are not intended to be official transcripts. Instead, they are interesting observations and thoughts for your consideration.

Favourite quotations

- Areas of investment don't make opportunities; brains make opportunities.
 - I don't know where stocks will be 3 or 5 years from now, but I do know where they will be 10 to 20 years from now. They will be higher.
 - If you rule out situations that actually turn out to be good, it's not nearly as damaging as ruling in situations that turn out to be bad.
 - In general, there are more problems with poor managers than with poor compensation systems.
 - You can't time the market, so there's no point in trying to wait for a major market disruption to provide an investment opportunity.
 - Regarding silver investment: I bought it too early, and I sold it too early. Other than that, it was a perfect trade! It shows how much we know about silver. Nobody asks us about silver for a good reason!
 - Regarding role models: Choosing your heroes is important. You should try to marry "up" and try to find someone willing to marry "down".
 - Very smart people do very dumb things, and we want to find out who they are so we can avoid them!
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Investment advice

- **Think 'buying a business':** When preparing to invest, read everything you can in relation to investing and on other subjects as well. It's important to fill your mind with what Mr. Buffett called "competing thoughts". The idea of business ownership is critically important – if you wouldn't want to own a business in its entirety, you have no business owning 100 shares.
- **Margin of safety and valuation:** Berkshire favours investing in businesses within its circle of competence where it has some degree of certainty. In general, Mr. Buffett is prepared to pay a price close to fair value because you don't need a huge margin of safety when you don't think you're wrong. He stressed that investors shouldn't try to get too precise in their estimation of the value of an asset but that they should always feel they are getting a discount. Overall, it is often better to buy at a reasonable price.
- **Dangers of a short-term focus:** Mr. Buffett stated that investing for short-term gains is unhealthy. There are huge percentages of stocks and bonds held by people who could change their minds tomorrow. Participants who don't buy and hold will experience different consequences. But this is not new – markets do unpredictable things at times, we saw that in 1998 and 2002. It's a fool's game to try to beat the markets every day, week or month. Mr. Buffett lamented that portfolio theory taught widely around the world doesn't work in the real world.

- **Use common sense:** In responding to a question related to Berkshire's investment methodology, Mr. Buffett stressed the circle of competence concept. Investors must invest in areas they understand. Ultimately, he claimed that the majority of ideas end up in the "too hard" pile, suggesting that it is not possible to value all businesses, all of the time.
- **Defining risk:** The financial world measures volatility, but volatility is not a measure of risk. Mr. Buffett told a story about buying a farm in Nebraska for a price that was considerably less than what the same property would have sold for a few years earlier. He suggested that the beta of this asset would be higher after the price had fallen significantly and therefore, according to conventional finance theory, the asset had become riskier. Common sense would have caused one to disagree with the implication that buying the property at a more attractive price was somehow riskier. Mr. Buffett argued that risk comes from the underlying investment, and possibly from not knowing what you are doing.
- **Assessing corporate managers:** In response to a question about assessing management without the benefit of a personal meeting, Mr. Buffett suggested that investors should read as much as possible. He added that Berkshire does in fact invest in companies where they don't know the management. With respect to marketable securities, Mr. Buffett declared that an investor can learn a great deal from the management letter in an annual report. For example, if a management team chooses not to write or is less than candid in the letter, then an investor must question if that's where he wants to be. He cautioned against investing in good people with a poor business. Instead he suggested that it's much easier to invest in good companies with weaker management.
- **Patient equity investing:** Forced to choose between equities and bonds at 4.75% (long-term US bond yields), Mr. Buffett would select equities. While his expectations would be moderate, they would exceed 4.75%. You don't have to have an opinion about whether to invest or not every day – if you're invested in companies that are doing fine, just keep holding them. Typically, dramatic market-changing events occur that are followed by prolonged periods of market calm. Most of the time there is no reason to expect a major change is about to occur; we are probably living in one of these prolonged periods now.

Berkshire Hathaway

Who will lead Berkshire in the future?

- The annual question regarding succession at Berkshire was answered succinctly. Mr. Buffett stated that he is looking for one or more persons with both the wisdom of experience and the ability to foresee possibilities that have not already occurred. He explained that the challenge is finding someone who can scale up because running \$100 billion is not the same as running a substantially smaller amount because of limitations in stock selection and the time it takes to build meaningful positions.

The value of Berkshire Hathaway

- Mr. Buffett admitted that while the value of Berkshire is simply equal to the sum of its future cash flows discounted back to today, it is a difficult figure to calculate. He went on to explain that an important estimation is the value of the retained earnings component or the value of capital not yet invested. This value is ultimately a function of investment skill and as a result, this capital could be worth in excess of 100% if invested well. To this discussion, Mr. Munger added that Mr. Buffett is a ferocious learner and that his judgment has improved with experience. He maligned the US system of retiring people and passing on management to others at 65 years of age as shortsighted (implying there is indeed value in experience). Mr. Munger concluded that while the future for Berkshire Hathaway won't be as brilliant as its past, it will be fine.

Global investing

- Mr. Buffett stressed the importance of fully understanding foreign-listed companies before increasing Berkshire's global exposure.
- Stringent reporting requirements pose a challenge to Berkshire as Mr. Buffett explained that the company prefers not to advise others as to what it is doing.
- In response to questions about Chinese banking concerns, Mr. Buffett indicated his belief that any growing pains in the system would be overcome by the strength of the Chinese economy – he also noted that the US has had banking problems in the past.

Reasons to be cautious

- While not expecting an engineered credit contraction, Mr. Buffett explained that exogenous events resulting in widening interest rate spreads and weaker equity prices could happen. He went on to invoke the famous Mark Twain saying that, "history doesn't repeat itself, but sometimes it rhymes".
- With respect to corporate profit growth in the 7% to 8% (versus a historical average in the 4% to 6% range), Mr. Buffett stated that corporate America is enjoying the best of all worlds at the current time – a circumstance that won't continue indefinitely. Mr. Munger added that it is not a time to swing for the fences as things do turn in the financial markets.
- **Derivatives:** Berkshire makes money with derivatives so is not against them, but rather, it is the lack of transparency in the system that causes worry. This lack of transparency hides the true extent of leverage and Mr. Buffett made no claim as to knowing when a problem would occur, only that one would eventually surface. Interestingly, he offered deficiencies in accounting as a contributing factor and added that some people are compensated on flawed accounting.

General comments

Global warming

- Mr. Buffett stated that given the scientific evidence, the odds are favourable that global warming is a serious issue and that it will be important to address it sooner rather than later. Mr. Munger, in customary fashion, suggested we would probably all be happier living in a warmer climate. He went on to add, with reference to the historical adaptability of the human race, that while there will be dislocation, climate change is not the end of the world.

Impacts of the sub-prime lending market

- Mr. Buffett said succinctly that many people who bought houses shouldn't have done so. In his opinion, there is unlikely to be a spill over into the broader economy, provided unemployment doesn't rise significantly and interest rates remain low. There was a lot of ill-advised lending – he offered the financial reports of large banks as evidence that they were extending credit to people with low initial repayments but higher levels in the future. Today, there is an abnormal supply of housing and there will be plenty of misery, but it is unlikely to be a huge anchor on the economy. The accountants also allowed profits to be reported where they shouldn't have been and securitization of mortgages accentuated the problem, making so much liquidity available to the market. The overhang in some markets is huge.

US dollar

- Mr. Buffett suggested that the US dollar would continue to decline somewhat given existing US government policies. In terms of investments, he suggested that the best protection lies with US exporters – however, this is a relatively minor factor in Berkshire's decision-making process. He went on to comment on how well the US economy has fared in the declining US dollar environment, how sophisticated Europeans are in dealing with currency issues and suggested that Americans will have to think more about currency issues in the future.

Private jets = excess?

- Mr. Buffett stated that he is in favour of executive jets because they have been a positive factor in generating returns for Berkshire shareholders. He went on to explain that without them, Berkshire executives would be unable to travel as extensively as they do to investigate investment opportunities. Mr. Munger added that he is solidly in favor of private jets – with a humorous, between the lines reference to Berkshire's ownership stake in corporate jet company, NetJets.

Ethanol fuel

- Mr. Munger offered a candid assessment of ethanol as a fuel source, suggesting that the amount of oil required to turn corn into ethanol is about the same amount of oil that is generated, and the resultant shortage in food supply will drive costs higher. He concluded with his opinion that it was the dumbest decision he had ever heard!

Management compensation

- Mr. Buffett said executive compensation has a natural tendency to rise given comparisons with that of other executives. In addition, the lack of power and will of most compensation committees tends to inflate executive pay. Mr. Buffett and Mr. Munger made it clear they are not in favour of executives being compensated (or penalized) for business results driven by variables they do not control – the effects of commodity price changes on business results are an example. They used an oil company as an example suggesting that earnings driven by the changing price of the commodity were a much less valuable indicator of management performance than metrics such as finding costs.

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