

Notes on “A Morning With Charlie” forum with Charlie Munger, held in Pasadena, CA on 7/1/11. Prepared by Pat Dorsey

This document is based on written notes. Some comments from Mr. Munger are verbatim, while other comments are paraphrased. Editorial commentary is in bracketed italics, and represents solely my opinion.

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Munger began with some comments on Berkshire’s acquisition of Wesco, noting that he thought Wesco shareholders did quite well in the deal. “Because Berkshire had a spate of losses from earthquakes and whatnot – there was a lot of uproar in Europe – Berkshire’s stock stayed at a price, and went to a price, that was way lower than either Warren or I ever had anticipated, so Wesco shareholders got more Berkshire stock than we really had intended.”

*[An interesting comment, given WB’s statement at the BRK meeting that “**If Lubrizol had wanted to use stock, we would not have done it. We would have been giving away part of the businesses we already own...you can draw your own conclusions about our calculation of intrinsic value from that statement.**” Seems like both parties think BRK’s shares are undervalued.]*

He then moved on to a favorite theme – the importance of using multiple mental models to solve problems. Munger used the example of overpriced candy bars in movie theaters, the purchase of which can’t be explained by the economic theory of marginal utility. In his opinion, you need to add a mental model from another discipline – psychology – to understand that the reason people buy overpriced candy bars (and overpriced options on new cars) is that the cost of the candy bar or option package is small relative to the cost of the movie tickets or the automobile.

The second example he gave was the failure of massive Keynesian stimulus to pull Japan out of its economic slump after the real estate bust, which puzzled the economics profession since the orthodoxy was that such spending should boost growth. Munger thinks the answer is simple -- Japan is an export-dependent economy, and got tons of new competition from Korea and China in many of the same markets, so of course it wasn’t going to do as well as it did before those two nations adopted capitalist systems.

Munger criticized the tendency of many people to grab at the first explanation they came to, and assume that's the answer. He thinks a "checklist approach using multiple approaches makes much more sense. He noted that he recently re-read a book because he admired it so much by Matt Ridley called the Rational Optimist. A terrific book... Ridley is charmed by the way free market capitalism has changed the world. Over and over he says the reason free market capitalism has worked so well is division of labor. But this is a totally inadequate explanation...use multiple factor approach and you get a different answer. What about the effect of competition allocating capital – via business success/failure – to managers who can succeed in competitive environments? Competition allocates resources to those able to use them most effectively. Also, proprietors of successful businesses constantly get positive reinforcement as they succeed, which "does not happen with the guy at the Department of Agriculture who gets a salary and can't be fired."

"You get a more adequate explanation if you look at multiple factors rather than just glomming onto the first one that pops into your head."

Moved into discussion of Blue Chip Stamps and use of float...had to find something to do with the money. "What was amazing was that in decades, we only found three things to do with it – buy Sees Candy, buy Buffalo News, and buy control of Wesco. That is very interesting...amazing amount of patience, because we had something else we could do with the money while we were waiting for good acquisitions to come along...we could buy marketable securities. Most companies are not set up to be able to do this with their excess capital."

"Buying control of Wesco was the worst thing we did, because the savings and loan never made more than a fraction of what Sees or the Buffalo News did. Even so, Wesco's shares went from \$5 to \$385...that's not the best result in the world, but it's in the top 1%."

Some folks may have done better, but we don't care. There's nothing more counterproductive than envy...there's always someone who did better than you. "Of all the grievous sins, envy is the most stupid, because you can't have any fun at it."

"Another advantage of the process the way we do it...we were learning as we went. When we bought Sees, we did not thoroughly understand the value of a brand. But we found that year after year, we could raise the price, and nobody cared. That is a powerful brand...and of course, that changed Berkshire. Its whole investment pattern was changed by increased knowledge we got from being active. The lesson there is we're all ignorant... none of us know enough now to successfully cope with what's going to come in the future ...if you want to do it well, you have to be a continuous lifelong learner."

"I sometimes say, "Pay yourself first," and the way you pay yourself is by protecting your own mind and making it better. I'd go so far as to say that's a moral duty. Rationality, the increase in

rationality is not just something you choose or don't choose, it's a moral duty to keep up as much as you reasonable can. It worked so well at Berkshire , not because we were so darned smart to start with...we were massively ignorant...many of the great successes of Berkshire started with stupidity and failure.”

[Told story about Berkshire buying three of the four leading department stores in Baltimore.]

“It's a pretty competitive business, and three in one city...it was the dumbest thing. Recognized our folly, sold them for about what we paid for them, used the money we had borrowed (on very easy terms) to buy securities at giveaway prices during a subsequent market panic.”

“Being an active and continuous learner means you can profit from your own asinities. That's what we did.”

“Many people graduating from Wharton now think they know absolutely everything. That is a considerable mistake. What's needed is continuous lifelong learning. It's not only helpful, it's a lot of fun. Can't you tell I've had a certain amount of fun doing this?”

“It's amusing that these economics professors spend millions of man hours groping at some simple problem so simple that I could do it with my left hand. “

[Moves on to the current investment climate]

Discussion of various causes of the credit/real-estate bubble...”Alan Greenspan was a smart man, but just totally overdosed on Ayn Rand at a young age. You can't have total freedom to create gambling games and foist them on people...much of what crept into i-banking was not legitimate capital raising, it was a gambling game in drag.”

“With derivatives, investment banking brought back the bucket shops of the twenties. “

“The i-banks were aided and abetted by the accounting profession... which doesn't want any serious responsibility, the way I would define serious responsibility. They want procedures they can follow so they can say the job is done. In my whole life I've never approached a problem like that...I regard that approach as contemptible. Contemptible is too small a word.”

“What accounting figures express any contrition?...what major person in America has expressed any embarrassment about America during the bubble? – there's one, Jamie Dimon of JPM, he's written extensively in annual reports about accounting principle after accounting principle that is totally asinine. For instance, at the top of every boom, a bank's reserves have to go practically to zero...what kind of a person would think that is correct accounting? The answer is a Certified Public Accountant, or a professor of accounting.”

...

“I would bet that Dick Fuld, wherever he sits, does not have an ounce of contrition, even though he totally destroyed Lehman Brothers with his megalomania. And this is a very, very serious issue, because if you’re not going to be held back by contrition and shame, you need civilized procedures to prevent people from going crazy.”

[Discussion of fraudulent tax shelters sold by big accounting firms...] “Sure, the partners kicked out the people doing it, but did any of them express shame? I feel ashamed...I feel ashamed to be in the same *race* as people who behave like this.”

“We don’t need this kind of inventiveness in American finance. It’s ok to be a little boring.”

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“The investment scene is very difficult...I think Bill Gross has a good concept with the new normal. Bonds are lousy. Carefully selected stocks may produce decent results.”

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“HFT is legalized front-running. All these costs being taken off the top of endowments, pension funds, and so forth. Like letting the rats into the granary if you’re a farmer.”

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[Referring to current political situation] “Don’t like this extreme divisiveness...a shame because in history we have seen some real nobility, such as the Marshall Plan post WW2. After first WW, allies were very vindictive, result was chaos in Germany and rise of Hitler with massive cost in blood and treasure. After ww2, we said “we’re not going to be vindictive.” Japanese had marched our people to death, tortured our troops to death. Germans put Jews in ovens. What did we do with these people? We gave them money. That behavior was a credit to the human race.”

Had to name one person who made the greatest contribution to that, was probably John Maynard Keynes. Wrote this very powerful book, “The economic consequences of a peace.”

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“It’s hard to be totally optimistic when you see how our politicians are now behaving. Just say whatever plays well in soundbites to their own constituency, I find it very painful to watch.”

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“Combination of patience and opportunism will serve you well. The opportunities in my long life have been infrequent, and you just have to be ready. I recommend to you all the basic idea that when a major opportunity comes along, don’t be timid.”

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Q & A session [selective]

Q: Do you think the WSJ has deteriorated since Murdoch took over?

A: I love the WSJ, never really liked the editorial page. The one that I like best of the publications of the world is the Economist. I regard that as the best intellectual journalism of the modern world. I don't think the WSJ is as good as the economist.

Q: In 1955, a corned beef sandwich was 55c, now it's \$13. My q is about inflation. If U.S. dollar has lost 95% of value in past 55 years, how much longer until loses remaining 5%? Thoughts on inflation given money-printing and high debt. If US were a corporation, and each dollar bill were a share of stock, would you put a buy sell or hold on that stock?

A: I think it's pretty obvious that we'll have some more inflation, on the scale of 50-100 year periods. We're in a successful era of the civilization, have had growth of roughly 2% per person per annum for decades ...that is not failure, it's success. Huge success. Success with no precedent in the long history of mankind. That was a very good period for your darned corned beef sandwich. In that exact same period, think what happened in Italy. I once paid a hotel bill in Venice in billions of lira, you think you have inflation problems. What you've just described with horror is at the absolute top of my expectations...in fact it's slightly above it.

If every person in this room had to live the rest of their life with an investment return of zero after inflation, and we had a lot of inflation, I think you'd all be pretty happy.

Now, certainly there'd be a lot of disruption...look at Greece. Greece is contemptible. They don't want jobs, they want sinecures. It's like Jane Austen...the ambition is to sit on your ass and have an income as it rolls in. A job is a *failure* – it ruins 8 hours a day, five days a week. People with that attitude can't run a government.

If I had been running Europe, I wouldn't have taken Greece in. I think it would have been a no brainer. I would have said, we have a European Union, but not for nutcases.

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I have found that life is easier to take, if you use one simple mental trick. If something is really, tough, just ask yourself, "can I bear it if that happens?" If you reach the conclusion, yes, well, just smile and go on. And that's the way I handle inflationary risk.

Q: IN your financial activities, do you think you've added social value, and how might that value compare to what you might have added in a different profession?

A: A really good question. To the extent that all I did was decided what securities were going to go up in price, and just passively sat on my ass watching this money roll in to the Munger family, that's not much of a contribution to civilization.

The difference between me and all the other people who've done it is that I'm ashamed of it.

You may think I'm here out of some nobility of spirit...no, this is *atonement*.

Next.

Q: Would you like to see more value investors buy large stakes and run proxy battles at underperforming companies?

A: I have schizophrenia on this. Reminds me of Oscar Wilde's wonderful description of foxhunting: "The pursuit of the uneatable by the unspeakable." I don't think much of all those people running around like vultures raising hell, but I don't like entrenched mgmt either.

Q: Advice for raising young children – what kind of values?

A: Whatever values you want your children to have had better be demonstrated to them say after day. That's my sole advice.

Q: [inaudible] unemployment

A: Would be flabbergasted if it just bounces back. Looks like it will be a considerable problem for a considerable period. But that doesn't end life, you know. I was raised during the Great Depression – did not ruin my life.

Q: Investment management

A: I would not let pension funds have 8% rate of return assumptions. With govt bond rates at three and common stocks yielding pretty low, troubles in business, how do you come up with 8%? Well, you come up with it because it's what you want...you tell people what they want to hear so that they'll keep paying you. And they want to hear it because it means they don't have to do anything painful. That's not the Munger system. The Munger system is that you go through life looking for pain and taking it in advance. That makes you a safer protector of yourself, your family, your friends, your employer, and everyone who depends on your judgment.

Q: Books you would recommend, out of books you have read in the past, which do you regret reading.

A: [Answer went off on an interesting tangent. CM talked about how much he loved reading Arthur Conan Doyle as a kid, and how enormously popular his stories were at one time. Recently, picked up paperback of ACD's collected works to take on vacation to Minnesota, and boy was it awful. Lesson is that he was wrong about how good a writer ACD was. Told a second story about opposing a plan to change the golf course at his country club, but once he saw the results, realized he had been "a total horse's ass."]

I know I'll perform better in life if I'm constantly rubbing my own nose in my previous mistakes. You take some of the pain out of being foolish if you take joy in running your own nose in mistakes...that is a wonderful trait and I recommend it to everyone. It certainly works for me. The nice thing about it is you'll never lack for opportunities. You will have no shortage of opportunities to exercise this wonderful talent.

Q: How would you select an investment manager, esp without much of a track record?

A: It's really, really hard. Lots of people are fine if they stick in a little niche, but they can't scale.

Q: [inaudible, about insurance]

A: Well, insurance has always been a mediocre business, and it's living up to its potential.

Q: How will the U.S. get a real energy plan?

A: Reminds me of Dickens, "Best of times, it was the worst of times." Worst is that people thought they could make the energy problem better if they turned corn into motor fuel. This is one of the most asinine ideas that has ever been presented. It's just now beginning to grip people how stupid this is.

On other side, Iowa gets 20% of power from wind. [Long discussion of solar.] We're going to get a better national grid, though it's not coming fast enough...There's no automatic right of eminent domain for someone who wants to build a transmission line. A natural gas company has a right of condemnation, so you just build your line. But you have no such right if you're talking about power transmission. I regard that as stark raving mad.

That's the main problem for your problem and grandchildren, is solving the energy problem, and now it looks solvable.

Q: Howard Buffett as Chairman post-WB? Why not Bill Gates?

A: Commenting on individual family members of Warren Buffett, or individual directors of Berkshire – and their respective merits? I'm a bold and crazy man, but I'm not that crazy.

Q: What would be your advice to others for judging management?

A: I can't tell you how hard it is as an investor....I know a company that we have followed for years and it is the best company with the best manager with a great culture, and an interesting product...and CEO has just made an acquisition that I regard as awful. All managers will disappoint you sooner or later. I don't think there is any way to not be surprised...

Q: USB, WFC best actors, but in bad neighborhood – dangers?

A: It's a compromise – like what my wife did when she married me --- not all managers are going to act perfectly. What you want is self-reflection – managers that can admit mistakes.