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# Ruane, Cunniff & Goldfarb Investor Day

May 20, 2011 – St. Regis Hotel, New York City

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*Remarks have been edited for clarity and relevance.*

Let me introduce our research team. On the dais to my left is Rick Cunniff who, most of you know, is the co-founder of our firm. On my right is Greg Alexander and to Greg's right is Joe Quinones, who runs the operations of our firm as well as those of Sequoia. To my left are David Poppe, president of our firm and co-manager of Sequoia, Jon Brandt, and Greg Steinmetz.

Finally I'd like to introduce the rest of our team who are seated in the front of the room. In alphabetical order, they are Girish Bhakoo, John Harris, Jake Hennemuth, Arman Kline, Trevor Magyar, Will Pan, Terence Paré, Rory Friday, Chase Sheridan, and Stephan van der Mersch. I'd also like to introduce Jon Gross who is our director of client services. In the front row are the directors of Sequoia: Roger Lowenstein, Bill Neuhauser, Sharon Osberg, and Bob Swiggett.

We're going to follow the same format that we have in the last few years, which means that we're going to respond to your questions from now until 12:30. We have to vacate the room by one o'clock but we'll be around between 12:30 and 1:00 to meet you and respond to any questions that you might still have for us. With that we're ready for the first question.

**Question:**

Can you present a case study on Valeant and how you discovered it and the key insights that you gained?

**Rory Friday:**

Valeant is a specialty pharmaceutical company. If you want to do a case study on the way we found the company — we went through a lot of financial releases, news online, and blogs — we look anywhere we can find an idea. We came across a fund manager whom we knew and that person had talked about an extraordinary manager at Valeant Pharmaceuticals.

We don't buy everything that we see, obviously, but we went through the company's SEC filings and conference calls and we saw that the CEO, Mike Pearson, appeared to be pretty extraordinary. Fortunately, we were able to meet him about a week after we came across the company. What attracted us to him was that he was taking a different approach to the pharmaceutical industry. He had worked at McKinsey for twenty-three years and headed its

global pharmaceutical practice. Valeant had gone through a whole host of issues. It had been losing money for a number of years and sales had been flat.

Before Mike, it was run by Milan Panić. But he had some issues — that's an understatement. Anyway Mike Pearson went in and restructured the company. It was in about eighty countries; he narrowed it down to less than fifteen.<sup>(1)</sup> He sold off a number of operations and he focused on the businesses that were the best. Valeant ended up with branded generics businesses in Poland and Mexico, and some neurology and dermatology businesses in the US. Mike also merged Valeant with Biovail and he has been restructuring that company.

One of the things that attracted us to Valeant was that he picked his spots. He was pretty outspoken about avoiding areas where there would be large pharma competitors or competition in general. So one of the lessons is that it's nice to have somebody who avoids competition and picks his spots. You don't have to compete against smart people. That's a pretty good situation.

Mike's strategy is to buy proven products that are mature. He doesn't like to spend money on R&D, but he'll partner with businesses that have pipeline assets to which he can add value. He likes doing business in countries where he can realize competitive advantage because of the scale of his distribution. And he likes specialty pharmaceuticals, branded generics in selected geographies, and orphan drugs.

The basic idea is that big pharma companies are spending a lot of money on R&D. Over the last decade they spent billions and billions of dollars, and they haven't really grown that dramatically. R&D hasn't been that productive. The average cost to bring a blockbuster drug to market now is \$1.6 billion – \$1.8 billion. There are a lot of companies out there spending 15% – 20% of their revenue on R&D. Pearson is exceptional at restructuring companies; if he buys a company he can cut R&D and reduce SG&A without undermining the company's competitive advantages. Say Valeant acquires a company that has products in Poland; he may well take those products and put them through his existing sales pipeline and get rid of the Polish sales force of the acquired company. There's a lot of opportunity out there for the company to grow over time.

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<sup>(1)</sup> Recent acquisitions have resulted in expansion into a number of countries in Central and Eastern Europe.

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**Bob Goldfarb:**

I'll just add that there are some sectors or industries where we historically have not had large investments, and pharmaceuticals or healthcare is one of them. We did own some Johnson & Johnson in the mid-90s and at that time J&J actually had a highly productive lab in Belgium, which it had acquired from Janssen in 1962. Dr. Janssen ran that lab for a long time and it came up with one after another niche drug. No single drug was large in revenues, but there were enough drugs in these niches that in aggregate they were highly profitable. Then J&J came up with some big blockbusters. One was erythropoietin, which it had licensed to market from Amgen and they subsequently wound up suing each other. Risperdal was the second. Subsequently, J&J ran into the problem of the law of large numbers — Risperdal and erythropoietin were such huge successes that replicating them was very difficult. Dr. Janssen died and that lab is no longer as productive; so subsequently J&J has become primarily reliant on either licensing or acquisitions to fill its pipeline; and that's a less profitable model.

I've seen a figure for the pharmaceutical industry. I think it was a ten-year period but I'm not certain of that. The aggregate return on investment of all R&D for the pharmaceutical industry was 7.5%. That is just far below Valeant's hurdle rate and below ours. So if we were going to own a pharmaceutical company, especially in size, it would most likely be an unconventional company. Valeant certainly fits that bill.

**Question:**

Would you please give us your opinion on Wal-Mart at current valuations and perhaps touch on the threat posed by Amazon not only to Wal-Mart but to bricks and mortar retailers in general?

**Terence Paré:**

Amazon is definitely worth paying attention to. Traditional store-based retailers ignore it at their peril. In the short run I don't think that it represents a significant threat to Wal-Mart's bricks and mortar. But Wal-Mart is giving the internet attention. Just recently Wal-Mart announced an addition to its Site-to-Store program called FedEx Site-to-Store: You can order something from Wal-Mart's website — which gets significant traffic by the way — and it will be shipped for free to a FedEx store you choose and where you can pick it up. This is an efficient way of delivering products because Wal-Mart already has a sophisticated logistics system

and the incremental cost of adding your package to one of the thousands of trucks it has zooming around the country is practically zero. So to that extent Wal-Mart has potential to grow in the clicks and mortar business, and it will use its bricks and mortar to do so.

That's not to say that Amazon might not pick off categories here and there, but I don't see it as placing a big dent in product categories such as groceries in the near future. Dot-coms have tried to get into the grocery business before. They run for a few years and then go out of business because they can't make any money. People will keep going to Wal-Mart to get their groceries and to buy most of their stuff.

**Bob Goldfarb:**

I would say — and then I'll let David kick in — that as Amazon gets scale, it may become large enough in a number of geographies to have same day delivery. I know it's getting pretty close on many books. The problem that Amazon has with this model is that if it has that delivery capability in these big geographies, its customers may be at risk of being charged sales taxes. One of Amazon's advantages over bricks and mortar retailers has been that in states where it doesn't have a physical presence, it has generally been successful in selling goods without the customer paying any sales taxes.

**David Poppe:**

In terms of Wal-Mart's performance, it's not a stretch to say that performance recently hasn't been very good. The comps have been negative for awhile now and if you backed out food inflation they'd be even more negative than what it reported for the first quarter, which was -1.1%. So Wal-Mart has work to do there. I think management is focused on it but the performance hasn't been great. I'm a little less sanguine than Terence about the threat of Amazon, because Amazon, in category after category, is putting other people out of business and it will be a difficult competitor.

The one thing I would say — I'm not 100% sure that I'm right about this — but Amazon's core customer, there's probably not a huge amount of overlap with Wal-Mart's core customer. There may be more overlap with someone like a Target. Also I do agree with Terence that where food is the core traffic driver, I don't think Amazon is likely to take much food away any time soon. So Wal-Mart is in pretty good shape there. But again, Target, where

food is not the core traffic driver, might be more squarely in the headlights of Amazon.

**Terence Paré:**

One other thing on the sales tax issue — I noticed doing my taxes this year that the IRS is asking how much you've purchased online. So it's clearly in the wind that the government is interested in online commerce. And state and local governments, which collect sales taxes, are looking for sources of revenue.

**Question:**

I'd like to ask about another area that's new to you. I see that you've picked up IBM and Google. Google in particular — I'm wondering if you feel that unlike Warren Buffett you can predict over ten years how it is going to do. How do you look at a business like that, value it, find your margin of safety and so on?

**Chase Sheridan:**

You're right, Google is unusual for us. It first got our attention on a valuation basis because it seemed like an anomaly; the speed at which it was growing relative to the valuation seemed out of whack. But as you know we look for sustainable competitive advantages. So the first thing I concentrated on when I looked at Google was how sustainable its advantage in search was. What we found is that the days of someone coming up with a clever algorithm and competing against Google in search are essentially over. A lot of people may not understand that when you search the internet, first you have to crawl the internet, download the internet, and parse the internet. That takes a tremendous amount of investment and infrastructure.

Google owns more servers than anyone else. It owns a tremendous amount of fiber optic cable. It places its computer servers next to very cheap energy. Google has its systems built literally next to hydroelectric dams. So you're talking about a business with a tremendous amount of investment required. There's really only one competitor out there that is trying to compete directly with Google in search and that's Microsoft. If you look at the numbers — because the media don't always frame this with the numbers in place; there's a lot of hype — Google's revenue last year was a little over \$29 billion. Its operating income was a little over \$10 billion. Microsoft, in its online services, had revenue of \$2.1 billion and it had losses of \$2.4 billion. For every dollar it took in as revenue, it lost more than a dollar. Facebook is the big threat to

Google these days in a lot of people's minds. In display that's true, but Facebook is not directly competing with Google in search; so there's room for them both to do very, very well. Facebook will do well in display and Google will do well in display as well. But in search it's very hard to see a competitor coming up now — it's tech so I could always be wrong — but I think it will take a long time before anyone threatens Google in this area.

**Bob Goldfarb:**

Is it \$37 billion in cash?

**Chase Sheridan:**

Yes, probably more by now.

**Bob Goldfarb:**

Now it may be \$40 billion because they just sold \$3 billion worth of debt but it would still be net cash of \$37 billion. One of our concerns, or reservations, about Google is what it will do with that cash as well as the enormous amount of cash that it generates every year from earnings. How would you assess past acquisitions, Chase?

**Chase Sheridan:**

It's hard to assess them because in certain cases I thought management was nuts when it made the acquisition. YouTube is a great example — Google paid \$1.65 billion in stock for YouTube when it had sixty-some employees. Eric Schmidt, later in a deposition, said he thought that was about a billion dollars more than the company was actually worth. But Google wanted to keep it out of Microsoft's hands. So a cynical value investor might say that Google was crazy to pay that price, but as it turns out that decision has been born out. YouTube is an incredibly valuable property. If I could go back in time and advise Google on whether or not to buy YouTube and invest in it as it has, I would absolutely advise a repeat of the decision. Still one of the worries that we have is that Google, an extremely ambitious company, is headed by brilliant engineers whose goals may not necessarily be to maximize shareholder value. They are out to change the world. Changing the world can require very long term thinking with very high amounts of invested capital and that may not necessarily benefit shareholders.

The question is do you give Google a discount for that risk and if so, how big a discount? Right now, Google last quarter — grew revenue 27% year over year, which for a company of that size is just remarkable. It is valued at — depending on how much credit you want to give for the

cash — anywhere between 15 – 18 times earnings. So you can give Google a discount for uncertainty around how management is going to allocate cash flows and still find that the company looks pretty cheap.

**Bob Goldfarb:**

We just don't have any informed opinion on the value of the investment in self-driving cars that Google is experimenting with in Nevada. It's venture capital and that's a different game than the one we're in. Another point that Chase just raised with regard to YouTube is there is a risk, which possibly manifested itself last week with Microsoft's acquisition of Skype, that for defensive purposes these companies make acquisitions at excessive prices just in order to keep them out of the other guy's hands. There's an arms race, if you will, and it's possible that unilateral disarmament might be the best outcome for the shareholders. But I wouldn't necessarily predict that is going to be the most likely course of action.

**Will Pan:**

On IBM ... Just to clarify or add my two cents to what Mr. Buffett said at this year's annual meeting, he said technology — now we're talking about information technology — is an extremely fertile area to look for growth because the world does need to get more productive. The problem is that there are so many big winners and big losers. And it is difficult to predict.

The nice thing about IBM is that it's really a comprehensive portfolio. You're not betting on one specific technology or one specific company bringing that to fruition. IBM is very comprehensive both in the types of products that it offers and in the ways that it can deliver them to its clients. It has the services functionality for really complex analytical offerings and it has software, which is really high margin, and the hardware as well. So it can really offer a one stop shop to its clients and that is one reason why it has such a valuable brand. Of course, with any portfolio you have to manage it and that is a little bit more difficult in technology than elsewhere. We think that the management team at IBM is extremely capable, one of the smartest in the field. It really has the deck stacked in its favor — and IBM has been staying abreast of technology enterprise IT for generations. That's something embedded in the culture.

It has the deck stacked in its favor because when IBM sees a trend, it can build on it. IBM has a

tremendously productive R&D function that it spends \$6 billion a year on, about 6% of revenues. In other situations where the most important work or the most promising work is being done at start-ups where the equity holders have a lot of upside, IBM can afford to pay more than others but still get a good return on investment; its unparalleled global distribution network enables it to generate greater revenues and earnings from the acquired entity.

And IBM has turned into something surprisingly predictable. This is a company whose management team has established a very credible roadmap to almost double operating earnings per share by 2015 with very high returns on invested capital, bolstered by significant share repurchase. We see that IBM has a lot of levers to pull to deliver on its promise and we find it both a compelling and a conservative promise.

**Bob Goldfarb:**

While we favor an R&D light model in pharmaceuticals, that may not be appropriate in information technology, as evidenced by the problems that Hewlett-Packard is having because of underspending on R&D under Mark Hurd. We like the fact that IBM is devoting a fair percentage of its resources to research and development.

**Question:**

Can you talk a little bit about MasterCard and how that compares to Visa — they seem to be extraordinarily good businesses to me. They have huge worldwide potential and, despite some litigation that's going on with them and government involvement, it seems to me that they are very good long term businesses in basically a duopoly.

**John Harris:**

You sound like a pretty astute stock analyst. I don't really disagree with anything you said. There are alternative systems like American Express, Discover, and Paypal, but there are only two principal networks for credit cards issued by banks and which account for the great majority of payment transactions in the U.S., MasterCard and Visa. Owning them doesn't do great things for your blood pressure because there's a lot of regulatory — I don't know if I'd call it risk — but there are a lot of regulatory issues arising around the companies. Clearly the economics of the ecosystem that they live in will change over time; they are already changing significantly on the debit side of the business. There may be a delay in the implementation of that but it's going to happen.

This may be slightly out of consensus, but my personal view is that it's going to change on the credit side of the business also. It's a question of when rather than if. But I think what the companies have shown is that they really are immune for the most part to changes in the amount of money that's floating around the payment space because there are only two of them and they really are a natural duopoly. Over time it's been demonstrated — in fact it was demonstrated pretty recently — that trying to recreate the networks that they've built is virtually impossible. If you own an asset that's essentially irreplaceable and there are only two of you who own it and you both compete in a very rational way and don't try to chase business by underpricing one another, it's very hard for your customers to try to recoup some of the pain they are feeling from you.

So the banks are going to make less money moving payments around the world than they used to and the banks at the end of the day are the card networks' customers. But it's not clear to me that the banks are going to pay the card networks any less in the future for their services than they paid in the past. So Visa and MasterCard are going to do okay over time.

In the not-too-distant future, the card will be a thing of the past and everyone is going to pay with a telephone. The telecom companies are aware of that and they went to the card networks and asked to be cut into the vigorish, basically, that is involved with a payment transaction. The card networks offered them something — it is not clear what it was — but I don't think it was sufficiently attractive to the mobile operators. So they decided they were going to go start their own payments network. They created a joint venture, and there were some big name telecom carriers involved with it. They selected Discover as the payments network that was going to facilitate transactions in this new ecosystem. They wound it up before they even got started. It was the quickest surrender you've ever seen.

So that really speaks to the durability and the extent of the competitive advantage that those companies have; so I think they are going to be around for a long time. There will be bumps in the road and there will be scary moments when regulation changes and when lawsuits are settled. But it's probably a good bet that the earnings of both of them will keep increasing at attractive rates over time.

**Question:**

Can you say something about the methodology or models you use in locating energy companies?

**David Poppe:**

We don't have any good models. Much of the performance of oil companies correlates with the price of oil, and we don't have a viewpoint on the price of oil long term. However, there is still room for management to make a meaningful difference in the performance of companies. The only energy company we own in Sequoia is Canadian Natural, and we have a microscopic position that we took at the bottom of the market. In '08 it got so cheap — Greg and Girish knew it very well, but it got so cheap it just seemed absurd compared to the resources it had in the ground; so we bought some. But it quickly ran away — we wanted to pay a rock bottom price. So we ended up getting a very small amount. In retrospect, obviously we would have been wise to pay a little bit more.

CNQ is uniquely good. Its investor day was here yesterday and I was in this room watching management. CNQ has an enormous amount of assets in the ground. It has the ability to more than double production over the next ten years. If you look at an Exxon or any of the other majors they have a difficult time growing production and replacing their reserves. CNQ — not only can it increase production but it's almost all oil. It doesn't need to grow natural gas to grow production. It's unusual for an oil company these days to have that much opportunity to grow production over time. So we like owning it.

**Bob Goldfarb:**

I would add that one methodology that we use across all industries is that over the last few years we've become more CEO intensive, skewing a little more to the jockey rather than to the horse. We've found that terrific jockeys have the ability to turn nags into Whirlaways, Secretariats, and Affirmeds. That's what happened with Mike Pearson at Valeant as Rory was discussing. Murray Edwards, who is behind Canadian Natural, is just a very, very smart guy to bet on. That was part of the methodology if you will.

**Greg Alexander:**

The oil business, as they say, is a very difficult business. It requires technological skill. I'm not saying anything you probably don't know, since you asked the question, but it requires technological skill

— a lot of it these days. It also requires financial skill. There's a lot of capital to allocate. In a normal business you're just allocating the profits at the end of the year; in the oil business you're also getting back all the money that you spent to drill the well. You have to reallocate that capital, too. You might be reallocating a quarter and in some cases up to a half of the market cap of the company, reallocating that capital every year. So your capital allocation skills are perhaps more important than in any other industry.

There are also strategic considerations — all these new fields and global politics in the case of some of the big companies. To run an oil and gas company these days is really a very challenging, complicated job. And good CEOs are really good. As Bob said, it's very CEO intensive.

**David Poppe:**

I would add the other thing about CNQ that's so interesting, because capital allocation is such an issue, is that it can allocate almost all its capital in Canada. That's so much more attractive than allocating your capital in Africa or some other crazy region of the world. It has all these opportunities in its backyard; that also is attractive to us.

**Question:**

It's been about a year since you started purchasing QinetiQ. I'm curious to know when you started purchasing it, what you thought was going to happen in the year that's passed, and if it didn't happen why it didn't happen — and what you see for the next year.

**Bob Goldfarb:**

I'll start and then I'll turn it over to Arman. The initial purchase of QinetiQ was my decision and it was a wrong decision in retrospect. The reason why we made that initial decision was that we had such confidence in Leo Quinn, who had run De La Rue. When he left De La Rue, we said that we would look favorably on the next company he joined as CEO. In retrospect, our mistake was giving the pen to Leo Quinn because two things happened. One, he found that when he got inside QinetiQ it had a lot more problems and was much more challenging than it seemed to when he looked at it from the outside. Two, the environment for defense spending in both the UK and the US is certainly more difficult than I suspect he assumed at the time. But why don't you follow through, Arman?

**Arman Kline:**

I think Bob hit the nail on the head. Leo has done a good job with the hand he was dealt — I don't think he realized how difficult it would be when he took over the company. He thought the UK would be potentially tough; I don't think he realized the US would be as tough as it has been. The Obama Administration started insourcing a lot of the outsourcing work and that put price pressures on. That said, given the hand he was dealt, he is doing all the right things. He has delevered the business much quicker than I would have imagined, or I think any of us would have imagined.

He's restructured it; he got a very stubborn union to agree to a pretty impressive reduction in the workforce and much more flexibility going forward. He believes the US business will turn around; others in the US industry are now singing that same song. So hopefully he'll be right. We'll find out what's going on next week when it reports. I'll be over in London for that. In the meantime the company has launched some successful products, which are helping him with the deleveraging and we'll see whether or not he has any more up his sleeve.

QinetiQ right now is in a tough position because its end markets are in flux and under pressure, and the company itself is in flux and under pressure. So this is a tough time. This was always — even when we made the initial investment — we thought this would be a two to three year turnaround. We knew this would be a tough year and it was a tough year.

**David Poppe:**

I would also say on QinetiQ that one good thing long term is that it's in a very protected industry. Government defense contractors — the security clearances are very tough. There's not an abundance of competitors. When you see the multiples for private market transactions, they tend to be relatively high. That's not to say QinetiQ will ultimately realize a higher value. But there is value in the business even though its market is very difficult right now.

**Question:**

One of your new investments is Goldman Sachs — there's a fair amount of controversy about Goldman these days. I'm wondering what the thesis is and how you're looking at the investment.

**Jon Brandt:**

Goldman is definitely not a fun stock to own if you want to read the newspapers or magazines like *Rolling Stone*. But we still think it's the preeminent investment bank. Goldman has franchises in mergers and acquisitions, and in stock underwriting, which we think are still very strong. Right now the price to tangible book is about 120%. Goldman has compounded its capital since going public at 20%. It has been investing a lot in emerging markets over the last few years, hiring a lot of people, building technology infrastructure. If I had to guess I'd say maybe 15% – 20% of its revenues are coming from those territories that are growing so much and where the company has strong positions. Because it has been investing so much, there hasn't been a lot of profit dropping to the bottom line; so over the next few years you may see greater profitability in those countries. Right now it is very overcapitalized and the company has tremendous amounts of liquidity that are penalizing near term earnings while management waits for some regulatory clarity on some of the issues like the Dodd-Frank bill in Congress and the Basel capital standards internationally.

Obviously Goldman had some business practices that came under the microscope during the crisis and continue to be under the microscope. Senator Levin in Congress has referred his recent report to the Justice Department. The Justice Department looked at all these trades the company did in '07 – '08, — '06 maybe more to the point — last year, and Justice decided not to do anything about it. Goldman paid \$550 million to the SEC to resolve some of the issues. There's the ability for the government to reopen these issues if there's new information. Goldman, for what it's worth, says there's no new information. I think everyone knows Goldman sold some CDO products that the company wishes it had back. But Goldman has a new business practices report outlining how it's going to change its practices so that people are going to pay more attention to suitability. I think you're going to see a new Goldman Sachs going forward. People are still going to yell and scream over all the money lost during the crisis, but Goldman's are far from the only people who would like to have some things back — notably the Senator's report had nothing about Freddie and Fannie. The government's going to lose a lot more on those two entities than it will on anything coming from TARP or any of the guarantee programs.

Goldman is definitely not your typical Ruane Cunniff stock. You cannot forecast its earnings quarter to quarter — not that that's true of all our companies, but there's an unusual amount of volatility in its results. But I think we've always felt that a lumpy 15% or even a lumpy 13% is better than an 8% or 9%. Goldman has \$65 billion of tangible equity. If it could earn a 13% return on all \$65 billion, the stock would be very rewarding at current prices. However, it is unclear whether Goldman will be able to deploy all \$65 billion in the business productively. If it can't do so, it may have the opportunity to deploy the excess capital in share repurchase at acceptable rates of return.

**Question:**

Are you doing anything in the utility field?

**Bob Goldfarb:**

Aside from our indirect interest in utilities through Berkshire's MidAmerican, we aren't doing anything.

**Question:**

I was wondering if you could talk about the two competing companies that you own, O'Reilly Automotive and Advance Auto Parts.

**Rory Priday:**

We own a little bit bigger position in Advance than we do in O'Reilly, but they both compete in the aftermarket for auto parts, selling things like carburetors, alternators, and fuel injectors. Historically we've owned O'Reilly because it has a superior offering in the commercial space — garages and mechanics. O'Reilly has been very good at that business. That's what it focused on; that's its heritage.

We ended up buying Advance a little over and a year and a half ago because we saw that there was a pretty impressive new CEO, Darren Jackson, who had joined the company from Best Buy, and he was focusing on the commercial business. Advance is trying to build a strong commercial offering while maintaining its retail offering, which has competed with AutoZone. We don't own AutoZone, but they are all good businesses. If you look at the returns on invested capital for the industry, AutoZone is way up there, it might be 25% — then O'Reilly has a mid-teens return and Advance, since Darren's taken over, has improved the return on invested capital from about 14% to 18%. So it's a pretty good industry and they are probably all going to do well.

**Bob Goldfarb:**

There aren't too many retail businesses where the customer, in this case for hard parts, enters the store with a greater than 90% probability of purchasing if the part is available. It's not particularly price competitive; it's more about parts availability than it is about parts prices. Going back to an earlier question, I don't think they are very vulnerable to Amazon. There is a dot-com operation, which sells auto parts. I see ads for it in the *Wall Street Journal* and the *New York Times*. But if you need an alternator to get to work, I think you're going to try to get the part from the store locally ASAP rather than over the internet.

**Greg Alexander:**

I'll make a general observation, which is it's amazing how many of the companies that people have asked questions about so far today are buying back really gargantuan amounts of stock every year. In the case of Google, which is not, I can't see what else it's going to spend \$10 billion a year on. Driverless cars? But it's fascinating to me that at a time when if we put money in the bank, we're lucky if we get 1%, so many of our companies are — I'm just guessing wildly at this — buying back maybe up to half a percent of their shares a month or something like that. I kind of like the idea that in two months we get one year's worth of interest on all these companies.

**Question:**

What is your view on Berkshire and Munich Re's reinsurance businesses in the aftermath of the Japanese earthquake and tsunami?

**Jon Brandt:**

I like to look at Berkshire on a look-through basis. On normalized earnings, Munich Re accounts for about 2% of Berkshire's profits. Munich is not going to make its forecasted earnings this year because there's a high level of CATs. But I think it is going to have an operating profit. It depends on what happens in the hurricane season. But Berkshire bought its position at tangible book. If it buys in at tangible book and if Munich earns 11% – 12% on equity and for one year it doesn't earn a huge return on equity, that's not going to kill the investment case. It is in the volatility business, as an insurance company.

The question I asked at the Berkshire meeting was how much do Warren and Ajit reduce their appetite for CAT risk because Berkshire has this 11%

holding of Munich Re, a 3% holding in Swiss Re and the quota share with Swiss Re. Warren said that he looked at the investments in Swiss and Munich on an equity basis. He said he had \$4 billion in the two of them combined. I don't think it's going to make or break Berkshire.

**Greg Alexander:**

Insurance and banking are two of those businesses where the industry has a certain amount of equity that it's going to end up with and if it has more than that they find a way to make it go away. I mean, if they are smart, they buy back stock. But if they don't do that, they find other ways to make it go away. If they have less than that certain amount of equity, they tend to have a few good years. So really when you have an earthquake, on the one hand they make less money that year, but it increases the odds of a little better pricing the following year. It's kind of a zero sum game.

**Question:**

Do you have some comments on Idexx Corporation?

**Arman Kline:**

We've owned Idexx for almost ten years. The business continues to chug along. In a difficult environment — as I talked about last year at this meeting — we discovered and Idexx discovered that unemployment is a large headwind for its business. When people don't have jobs, they may keep their pets but they don't invest in pet health as much. Despite that headwind, Jon Ayers, who is the CEO of the company, and his team have done an excellent job. So we continue to own the stock. We sold it down a little bit when the market got very exuberant for awhile there. Our position was 8% of our assets at the top — that's a large position for us; so we reduced it because of its valuation. But we continue to like the business, we like Jon and we think they'll do well.

**Question:**

What are the nations you're invested in now and what is your expectation for the future in terms of international investments?

**Bob Goldfarb:**

That's a difficult question to answer. One way of cutting it would be to look at the domicile of the companies. Another would be to look at the countries in which those companies do business. I suspect in the case of a company like Berkshire, between its owned businesses and the companies in which it has

equity, the publicly traded companies, there's probably not a country in the world in which it's not doing business. So with Berkshire alone, we are in every country in the world. Maybe not Antarctica, which Sharon Osberg is an expert on. Or North Korea. Excuse me, Sharon just informed me that there are Coke machines in Antarctica.

**David Poppe:**

I think what you could expect going forward is that we are trying to source more income outside the United States. But we're also trying to stay focused on companies that have disclosure that we're comfortable with, management teams we can meet, and hopefully IFRS accounting standards. I don't think you'll see us wander too far past Western Europe. Never say never — there are some really top quality Western European companies that source huge amounts of their income from the emerging world. That's why we got interested in the first place.

The reality is we haven't done very well on our foreign investments to date; so I don't think you'll see us dramatically increase our exposure to foreign stocks until we become more confident that we can do it successfully. But you will see us look for more and more businesses that are sourcing a lot of their income outside North America.

**Question:**

You touched a little bit on the impact on Berkshire, but with regard to the earthquake, tsunami and the nuclear problems in Japan right now, and the talk of rolling blackouts, I have a three part question — one, do you see that impacting any of your other companies currently? Two, do you see that impacting any of the companies down the road? And three, do you see any opportunities from that?

**Jon Brandt:**

The impact on Berkshire besides the losses it's going to have to pay out is that perhaps the retro market and the regular reinsurance market will tighten and prices will go up. But the next big renewals for the US are July 1<sup>st</sup>; so it remains to be seen what impact that's going to have. Other than that, we're not really exposed to nuclear power. There are delays in the supply chain for automobile companies — we must own something that's slightly impacted — but I wouldn't think that would have a measurable impact on our portfolio overall, nor would it have a huge impact on opportunities.

**Greg Alexander:**

I would say that's a good question and a lot of people in Japan are scrambling to try to answer that question. The answers would be interesting if we knew them. But honestly it's not the way we're wired. We don't really think about things that way. We think about things that go on for many years, not responses to events that may have happened last month.

**Bob Goldfarb:**

The decline in the Japanese stock market that followed the tsunami and earthquake caused Jon Brandt to do intensive research on at least one Japanese company. It isn't in the portfolios at this point. It's possible that it might be at some point in the future.

**Jon Brandt:**

The Japanese stocks — I did a screen, and you would have thought that with ... Greg, how much is it down since '89, the Japanese stock market? It seems to go down all the time.

**Greg Alexander:**

Three-quarters or two thirds. In dollars it would be less.

**Jon Brandt:**

The stocks just weren't as cheap as ... the non-financial stocks were not as cheap as I expected them to be. And they bounced back pretty quickly.

**Question:**

Can you give a follow-up on Wal-Mart? If there continues to be a trend of people shopping online and actually not going into stores — I haven't been to a store during Christmas season for the last, probably, five years. I purchased everything online and that seems to be a trend. Could Wal-Mart cannibalize itself? How difficult is that for Wal-Mart to do? If Wal-Mart decided it needed to spend a lot more in terms of building an online presence, could it, given the pressures of Wall Street, make a massive investment and have negative EPS comps for a number of years to build out those capabilities?

**David Poppe:**

I would say the example of the newspaper industry is that these guys have a hard time changing their business model. Wal-Mart's customer base — certainly everybody in America is online now — but Wal-Mart's customer base is probably a little bit less living their life on the internet than Target's or Costco's customer base. I do think

shopping online is a challenge for the Wal-Marts of the world. If your traffic generator is food though, you're in a little bit better position than some other people whose traffic generators are general merchandise or certain hard lines. So it's an issue over time.

Interestingly, when you look at Wal-Mart and Target, they are both struggling to generate traffic. How much of that is the economy and how much of that is online is a really good question because I doubt that they are thinking about online. That's not top of mind for them. They are attributing it to other things. If in fact the reason that their traffic is under so much pressure year in and year out is online, I have to say I'm not sure they are really ready for it. While Wal-Mart and Target would probably both tell you they are spending a lot of money on the internet, they don't have the best websites in the industry and I don't think they will.

Amazon is a different animal built in a different way and it would be really, really difficult to copy. Can Wal-Mart and Target get better? Yes. Do they benefit from the fact that, at Wal-Mart in particular, food generates the trip? Yes. I don't think that's going to go online in a meaningful way soon. Does Wal-Mart benefit also from the fact that people like to look, touch, hold and feel the merchandise? I don't think the shift to on-line happens quickly; it would be really, really slow. So Wal-Mart should be able to address it but my feeling — Terence may feel differently — I don't think either Wal-Mart or Target is in a great position to change its business model nor would they.

**Terence Paré:**

Overall I pretty much agree with what David is saying. One thing I would add is that in addition to its efforts in this country, which I discussed previously, Wal-Mart has shown an interest in click retailing outside the US at Asda and with the recent purchase of a company in China that is largely online. So Wal-Mart is paying attention to it. Now when Wal-Mart makes acquisitions, it always makes me a little uneasy. It doesn't have a terrific record for paying good prices. That's just the way it is. The returns on capital for its foreign operations generally run below those in the US. It's willing to make those investments because management believes that it can grow into good returns and in some markets the company has been pretty successful with that.

But there will be some erosion in the US, a little bit here and there. It will take time. You want

to see what the produce looks like before you buy it. Also, we are social animals and in some places in the United States Wal-Mart is essentially the town center. People go there and just hang out. I'm not kidding — there will be a little cafe in the front and people will go there and just socialize. But online is very efficient for some things. People will do some business that way and more over a period of time.

In places like China where the retail market is still growing up, online may account for more and may develop faster if consumers are being trained to buy online from the very beginning. But as I mentioned, Wal-Mart already has its foot in the door there so we'll see.

**Question:**

I have a question about how you size these investments. Do you have size criteria or do you have a price, a rigid price criterion? Another question — do you expect to close the fund soon for new investors?

**Bob Goldfarb:**

I'll respond to the second question. If we were to close the fund, the principal determinant of that decision would more likely be not the inflows into the fund or the assets of the fund alone — but rather the aggregate assets of the fund and the separately managed portfolios. The real constraint is that we don't like to be restricted to large capitalization stocks. If we find that the aggregate level of assets may threaten to limit our range of choices, then we would reluctantly have to decide to close the fund. But we're not there yet and we'll see if we get there. You can see Sequoia's net flows from investors in each quarterly report. But you are not seeing the whole picture because you have to see the net flows in the separately managed accounts, which are significantly larger than the fund at this point, in order to get a pretty good gauge of where we stand with respect to that issue.

**David Poppe:**

I think about price criteria all the time. We pay different prices for just about everything in the portfolio and you could look at it and say there's no rhyme nor reason to it. But we're evaluating a whole set of criteria, not just price. How good is the business, how long is the runway? Do we think it could grow for five years or for ten years? Maybe we don't think it's a great grower but it's a solid franchise and it's ridiculously cheap. Every decision is different. I do think if there's one thing we look at the most, it would be the price we're paying

compared to the growth rate of earnings over time. That's simple but if you have a great franchise that's not growing you could still own it. Managements, great capital allocators — in the case of Idexx and Fastenal, we paid high multiples for those stocks when we bought them and they were really, really good decisions.

They fit ... they are of a piece with the idea that we're value investors. We paid a good price for those stocks. Qualitative issues in the end can matter more than quantitative issues. You've got to do a good analysis of the quality of the business, the management, the culture, and what you would want to pay for that quality. All these factors and more determine intrinsic value, which is the present value of all future cash flows. Ideally, the size of the investment will correlate with the size of the discount to the intrinsic value of the business.

**Bob Goldfarb:**

We're pretty eclectic. When David and I were out at Morningstar in January, there were some rumors that they were going to reclassify Sequoia from large cap blend to large cap growth because of the addition of companies like Google and Valeant to our portfolio. Our cost on Valeant is seven times what it's going to earn this year and it is growing very fast. Is that a growth stock or a value stock? In our opinion Valeant and Google are both. I think Morningstar is going to use some judgment that's not formulaic so that Sequoia will probably stay in that large cap blend category. But even that isn't totally accurate. I'd say blend would be a better category because as I mentioned before, our threshold is quite a bit lower than the \$5 billion market capitalization that is often used as the tripwire for large cap. We're going to continue to be eclectic and blend — hopefully well.

**Question:**

Just as a follow-up to that, you've mentioned a few things today — the concentrated portfolio expanding, concentrating a little bit more on the jockey, tech stocks and so on. How different is your approach today than it might have been fifteen years ago?

**Bob Goldfarb:**

I think we covered some of this already. We're broader in terms of industry. We're broader in terms of geography. As I said, we're betting more on the jockey and a little less on the horse because we found that terrific jockeys have the ability to transform the horse. If you look at Berkshire, it

raises an interesting question. Warren Buffett has publicly said that his biggest investment mistake was buying Berkshire Hathaway and that he would be twice as wealthy if he had not bought Berkshire. If you just took Berkshire's share price relative to the value of the underlying textile business, Berkshire was overvalued. An investor who passed on Berkshire for that reason in 1969 and the next few years also made a big mistake. How do you factor in the value of a jockey like Warren Buffett at the age of thirty-nine working with a small pool of capital? It's enormous.

**David Poppe:**

I would say on the expansion of the concentrated portfolio, we've added not just people but really good energetic people. We're able to look at more stocks across more industries. I haven't been here that long, but from my perspective, for years it was Bill, Bob and Rick. And that's like Ruth, Gehrig and another Gehrig in the middle of your lineup. You don't need twenty people to look at stocks. We don't have Bill anymore. We've compensated for that by trying to look at more things and do more things and be a little bit more agile. So we've gotten broader because we needed to get broader. We have more expertise than we had in the past — because we don't have Bill — I think that's part of the reason. But the good news is we've been running a long term science experiment with your money and it's worked out pretty well. We own more stocks and our sixteenth best idea did pretty well last year. Going forward we feel confident that this model works the way the Bill Ruane-centric model worked maybe in 1992.

**Question:**

Let's say you like MasterCard — I don't know how much you invested, but how do you decide if you invest \$10 million or \$20 million?

**Bob Goldfarb:**

In the case of MasterCard, we bought it on the day of the offering. Do you remember what the factors were that dictated how much? Clearly we should have kept going.

**David Poppe:**

We thought 40 was a good price and 44 was too much. I think in general sizing positions is a function of two things. One, how much confidence we have in the idea — and the more confidence we have in the idea, the bigger we want it to be. We still adhere to Bill's old precept that your six best ideas in life are

going to do the best. You saw that with Valeant where we sized up really quickly — on an idea in which we had a ton of conviction.

Stocks like IBM, Google, and Goldman are all 2% positions. That was done for a reason, as we had maybe a little bit less conviction in these areas. We were pretty sure that we were right but we had some humility; so they are not huge positions for us. What also happens with sizing the positions is we have a lot of price discipline and occasionally things run away from us and we end up with oddball sizes, or not necessarily the size we wanted to get.

So two things — conviction matters a lot and then price discipline and how much we're willing to deviate from our price discipline. In some cases you could look at the Sequoia portfolio and say we've been penny wise and pound foolish. But it's sort of in you when you're cheap and it's hard to pay more than what you originally wanted to pay. It's very hard to rethink those decisions.

**Question:**

Could you comment on your holding of TJX?

**David Poppe:**

We've owned TJX, it will be 11 years this summer. It's been a wonderful stock. It's a remarkable business; it has a very powerful bond with the customer. It's a good retailer but where it really makes money is in buying surplus merchandise. One of the great things about TJ and about that market — this is true of its competitor Ross too — is that the incremental cost to manufacture more apparel is very, very low and the barriers to entry to the business are also very, very low. So there are always too many competitors and they always have incentive to overproduce. The margins on the 100,000<sup>th</sup> pair of blue jeans are really, really good even if the vendor is selling them for a low price. That makes it a very good environment if you're in the business of buying surplus. TJ's business model is very strong. It's interesting, when I've gone to apparel trade shows, I find the vendors don't hate TJ and Ross; they like TJ and Ross because TJ and Ross allow the vendors to overproduce, which is what they inherently want to do.

In this environment they've performed much better than I ever would have expected or anticipated. But it shows that the consumer sees a huge amount of value in the proposition — they are selling branded apparel for a lower price that you can easily compare to what's at Macy's, Nordstrom,

or Kohl's. They get it later and there are other negatives that you put up with. It's not as nice a store. But the model is very powerful and the value proposition is very obvious.

The number one skeptical comment you hear is that one day inventories in this business will rationalize because they rationalize everywhere — but they never have. As I said, there are some unusual factors in this business that suggest that inventories won't rationalize in the apparel business. It's been a very good holding, it's a reasonable multiple and another thing that's nice about it is that it's a very owner-focused management team. They buy back, as Greg was saying earlier, they are probably exhibit A — they buy back huge amounts of stock. So we have a lot of confidence as owners that we are going to get a good return.

**Bob Goldfarb:**

Carol Meyrowitz is just an outstanding CEO. I don't think a female jockey has won the Kentucky Derby yet, but in the Kentucky Derby of business at least one has.

**Question:**

Can you please comment on Omnicom?

**David Poppe:**

Omnicom is a holding company that owns advertising agencies. It is in another interesting industry, an industry that is very consolidated. There are really four big holding companies left. And it's an industry where clients worry about conflicts. But in a way that's good because it means the ability of customers to pick and choose and move among agencies is somewhat limited. It also means pricing is fairly rational. You see the margins for all the players are actually quite good. They are good year in and year out: In 2009 Omnicom's earnings went down about 20% — but the margins really were reasonably stable. Advertisers can choose to spend less and that does happen. There's some cyclicity there, but it is very, very difficult for the brands to spend nothing, and also very difficult for pricing to get too out of whack and margins to get too out of whack because you have a fairly limited competitive set.

The other thing is that it's a people business and in North America you can flex up and down on people very easily; so that also makes it good. The European holding companies, WPP and Publicis are very good and they do a good job — but they do

more of their business in countries where it's a little bit harder for them to flex up and down.

**Question:**

Another portfolio question — could you comment on your current thinking as to the percentage of the portfolio you want to have in government obligations? Does it relate to interest rates? Does it relate to the flow of ideas?

**Bob Goldfarb:**

It certainly relates to the flow of ideas. Our target is to be 100% invested in stocks. But the shortfall at Sequoia also reflects that there has been an inflow of money that's affected the percentage that's in governments. We've invested some of the net inflow but not all. But if we could find the right ideas at the right prices today we'd be 100% invested; that's our goal.

**Question:**

I wonder if you could comment on Mohawk and where you think we are in the housing correction generally?

**Terence Paré:**

We've owned Mohawk for a long time and if you look at what it's contributed to the return of the portfolio, it has been a drag — which is not good, obviously. On the other hand the market doesn't know what you paid for a stock and it doesn't care when you bought it. What matters right now for Mohawk is what we have now. When we bought it we had a company that was the second largest carpet manufacturer in the United States that had a pretty good ceramic tile business. It was run by a young and energetic guy. Bob mentioned the importance of the jockey. In the case of Mohawk, we've had a jockey who has done what I think is a pretty remarkable job in both recasting the company, making it virtually unique in the floor covering business, and taking it through the worst housing market that we've ever seen. And it has emerged at the other end of it — we hope that it's the other end of it — with a business that is in more markets and is more efficient and has more new products than it did when we bought it.

The fundamental problem that the company faces is end market demand, which is driven by consumer spending and existing home sales, primarily, and by new home construction. Commercial construction and remodeling are important too, accounting for around one-third of the business. But Mohawk's is mainly a remodeling

business. And what we and the company are waiting for is a kind of release of the pent-up demand for remodeling spending. We're seeing very tentative signs of that now in the commercial market. One of the reasons for that is that commercial real estate, as it turns over, there's more of an incentive to remodel. It doesn't face the same kind of anchors that the residential real estate market does. You don't have people underwater on their mortgages; you don't have these disasters with robo signings and paperwork that can't be sorted out so that even if you try to buy a home in foreclosure the banks can take as long as two years just trying to get all the paperwork straight.

There are both the economic issues of a general uneasiness on the part of consumers to spend and the continuing oversupply of residential homes. It's going to take awhile to sort that out. So how do we feel about the housing market now? Probably a little bit better, I'd say, than last year, not as good as I'd hoped I'd feel last year but a little bit better, and confident that we own a business that is better constructed to produce superior returns today than it was when we bought it.

**Question:**

It appears to me that there are three or four of you up there who have observed Mr. Buffett for three decades, maybe four decades. Some have suggested that this period of the last three years has clearly been his finest hour. I wonder if you would comment on that and I would like it if Mr. Lowenstein would add his observations.

**Roger Lowenstein:**

I think what's remarkable about him is his career has spanned so many cycles now, so many cycles that seem to have been the big one. If you go back to 1969 when he folded up his partnership and 1987 — I remember, actually we were talking about the dot-com bubble. There was quite a lot of talk that he'd lost it then too because he hadn't participated. So it's hard for me to say that this is uniquely good or that this is his finest hour. He's had a lot of good hours.

But maybe one thing that is different — I don't know if Burlington Northern will be his best investment, but certainly the good investments he's making now, the bar is so much higher because he has to allocate so much capital. So he is certainly facing — the bigger he gets, the tougher the challenge.

**Bob Goldfarb:**

I think if you just measured it objectively by the benchmark that he uses, which is Berkshire's compounded book value versus the S&P, I don't think by that benchmark the last three years have necessarily had the strongest outperformance. But you also have to factor in size. It was just so much easier to compound book value at a much, much faster rate than the S&P when he was working with a lot less book value than he is today. So again, objectively by the benchmark that he uses the answer would be, "No." But you'd have to factor in the amount of assets that he was working with and then you're in the realm of subjectivity rather than objectivity in terms of measurement.

**Question:**

Exit strategies you've used in investing in general?

**David Poppe:**

Exit strategy for stocks — the exit strategy ideally is you don't sell until you see some material change in the competitive position of the company. You realize either your analysis was wrong and you need to make a change, or the competitive circumstances around your business has changed. I think Fifth Third would be a good example where it was a really, really great company for a long time. It grew wonderfully and performed well but got to a size where management was making capital allocation decisions that were — Jonny can correct me — going to be difficult to make work. Then it becomes time to exit, when you realize there's been a change.

The other thing is, as Arman mentioned earlier, we sold some Idexx this year. Sometimes price forces you to make a decision. You believe a company is a terrific company but that the P/E just looks unrealistic and you think it would be very difficult for you to make a great return over time. Most of our sales over the years — at least over the years that I've been here — have been because the competitive position of the company changed. We tend to own businesses we like a lot, management teams we have a lot of faith in. We tend to maybe give them some leeway and the benefit of the doubt when they hit rough patches.

I can remember with TJX; it changed CEOs in the middle of the last decade and there was definitely some sentiment that maybe we should have sold the stock because it really did hit a rough patch. And I'm glad we didn't. Maybe that's the situation with

Mohawk these days, where the economic environment has been much tougher than we or management expected and we're seeing if Jeff can work through it. But in general when you believe the competitive environment has changed materially, it's time to rethink your investment.

**Bob Goldfarb:**

Again I'm going to have to enter the realm of subjectivity rather than objectivity. But subjectively I believe that most of the excess return we've earned over 41 years has been on the buy side rather than on the sell side.

**Question:**

You've talked a lot about the jockey. Do you have a framework on which you try to evaluate CEOs? Where do you get that information from? How much is coming from evaluating the public record of somebody versus talking to that CEO versus talking to people around him?

**Bob Goldfarb:**

I'll answer that question in part by saying that with the exception of the cases I've cited where the jockey transforms the horse, in many situations the jockey riding one of our horses may do spectacularly well, but if he or she were riding another horse the outcome would be a lot different. Carol Meyrowitz is sensational at running TJX, but she would find running Berkshire Hathaway quite challenging. As smart and as capable and as broad as Warren Buffett is, I'm not sure how well he'd do merchandising off-price apparel at TJX. So some of it is industry specific — insurance certainly plays to Warren's strengths. It's all about probability. He's phenomenal at probability. I have no idea whether Carol Meyrowitz or some of our other CEOs have that same skill set. So matching the skill set to the business is critical.

**David Poppe:**

You try to build a mosaic and it's not always easy. There are some people who don't believe that it helps you to meet with management — that you can get it all out of the public records. There are certainly people who have done really well investing that way. But for us, because we are looking at hopefully a ten-year holding period, we want to know the person and be really confident in the person. So we spend a lot of time with management — hopefully. There are some mega-cap companies now in the portfolio where it becomes harder to actually have a relationship.

You talk to people who have worked with that person in the past and who are doing business with him or her now. It could be a whole variety of customers, suppliers, distributors, franchisees, people who may have known the CEO in another company or another era. What kind of person is he or she? What kind of culture is it? Sometimes it's easy and sometimes it's hard. If you go to a Costco, you quickly realize that the store personnel are superior to other people you have met in retail and you figure out pretty quickly that the culture is really good. If you have a gem, you know it.

The public record matters. What is written in the proxy matters. How much respect does management have for you? How stupid do they think you are? How much do they think you'll tolerate? We talk to people who worked with the CEO in the past. Maybe the CEO had a tough job before he got this job. What kind of job did he do? It's a mosaic and we're trying to understand the person and the way he thinks, the way the company treats shareholders. We're pretty good at it, but we work very, very hard at it and it's not a formula.

**Question:**

The tone of this meeting in 2008 was much more somber. I'm glad to see a change. But in 2008, Mr. Goldfarb, you began the meeting by stating some concerns about the unprecedented printing of money and the possibility of a currency bubble. I'm wondering if you could follow up on that comment generally at this time and also if you could comment specifically on whether you observe that inflation risks these days are not necessarily in CPI but in asset inflation.

**Bob Goldfarb:**

I think you just transformed the tone of this meeting. Your question puts me in a very somber state of mind. My own feeling is that we're just repeating the housing bubble in a different form. We've substituted an unsustainable buildup of government debt for what was an unsustainable buildup of consumer debt. This one really feels worse to me and more dangerous. I think we're living in a time of false prosperity because we clearly can't have deficits that are 10% of GDP for very long. If you reduce that 10% to say 2% - 3%, it would have quite an impact on aggregate demand. It's not just the US; it's Europe, or most countries in Europe, as well. I am not optimistic that there's going to be a quick resolution to it.

Personally I think one could quarrel with some of the individual aspects of the Simpson-Bowles deficit commission's recommendations. But on the whole I thought it was an excellent piece of work and I fault the politicians. They did not constitute the supermajority on the committee to endorse it, which would have mandated a vote. I fault them but at the same time I understand them because when every single recommendation was polled with the public at large, it was rejected.

I think multiples or price earnings ratios are quite reasonable right now, but I believe they should be reasonable. If you adjusted earnings for the level of aggregate demand that would exist if we and some of the countries in Europe were running — you could add Japan to that — were running deficits closer to 2% of GDP than to 10% — again, we're entering the realm of subjectivity — I don't know what pro forma S&P earnings would be. But if aggregate demand were 6%-7% less than it is, S&P earnings would be a lot less. We saw how little American industry earned in 2009.

The least painful way of attacking this is through printing money and inflation, which has its own very adverse consequences. So it's a very dangerous period. Rick, do you want to comment? You've lived through a lot of dangerous periods. Does this one seem to be more dangerous than any of the others?

**Rick Cunniff:**

I would say yes. I've never seen anything which has as much bad potential as we have right now.

**Bob Goldfarb:**

Any optimists? Any of you? Any in the audience, please, one optimist! You're an optimist, are you?

**Investor:**

Yes. At the end of the day, we know the politicians aren't going to let the country go into default. We know that. They can't because otherwise none of them would have jobs and they would have to go home and cry about it. So we know that their political lives depend on a deal about the deficit. We know that something is going to happen. How good is it? I don't know. Is it going to make a huge impact? No. Is it going to make some impact? Yes. Is the IMF helping Europe? Yes. Is it enough? Probably not.

**Bob Goldfarb:**

And you're the optimist!

**Question:**

How do you evaluate your research team? What are your goals and expectations of them and how do you manage those goals and expectations?

**David Poppe:**

With a stick! We have a really bright team of people who are pursuing interesting ideas. A lot of stuff is bubbling up all the time. Our guys travel a fair amount; they see a lot of things. It's incumbent on Bob and me but also on the other senior people here to voice our opinions — we think this idea is better than that one. Ultimately we're the editors and we're the ones who have to make the decisions on the ideas that bubble up. Their job is to present us with a good set of choices and our job is to pick the best of those choices. Sometimes we've been really risk-averse. Sometimes we've probably erred on the side of caution.

Certainly the ideas that have been presented to us, if you look at your portfolios, there are some 0.1%, 0.2%, 0.3% positions. That's not intentional; that's not something we want to do. We've been really cautious about the prices that we pay for stocks. But ultimately the nut of it is their job is to present us with good ideas and our job is to make good decisions about those ideas. They've presented us with a really, really good group of ideas over three or four years now and that gives us some confidence going forward that at least we're not going to lack for places to put your money.

How do I evaluate them? It's easier than it sounds. We're a writing-intensive culture; so a lot of memos are moving around; we're seeing what their ideas are. I know where people travel; I know whom they are talking to. It's pretty apparent who's pulling his weight and who's not and I'd say honestly everybody's pulling his weight. It's more transparent internally than it might be for someone on the outside.

**Question:**

Buffett was quite optimistic in Omaha, I thought. Do Jon Brandt and anybody else who was in Omaha have any comments or reactions to what I perceived to be Buffett's optimism?

**Bob Goldfarb:**

I'll respond to that. I think because of his stature and his persona, it's almost impossible for Warren not to be constitutionally positive.

**Question:**

Just a question on Perrigo — I'm curious if it's the jockey or the horse. Could you talk a little bit about the reasoning behind that? I wanted to follow up on a question earlier — I could have sworn that a couple of quarters past I saw J&J make its way in and out of the portfolio. If I'm right, can you comment on why it made its way out. What fundamentally changed for you?

**Bob Goldfarb:**

Johnson & Johnson was the most nominal of positions. We owned 30,000 shares; so it was just de minimus. It made no sense to hold the position at that level and we opted to eliminate rather than to increase it. We far prefer the Valeant model. I'll let Arman speak on Perrigo.

**Arman Kline:**

I'd say it's the jockey and the horse. We're big fans of Joe Papa who came in from Cardinal Health to run Perrigo, really focusing on its core business of private label over the counter drugs. If you go to CVS and you buy the CVS brand of Prilosec, the heartburn medicine, there's a pretty good chance that Perrigo made it. We like the model, obviously. I won't call it countercyclical but it is somewhat recession resistant in that you see trading down from brands during tough economic times. Perrigo benefits from that. Retailers also earn more profits selling private label products. CVS generates fewer sales dollars but more gross profit dollars from selling the CVS brand than it does from selling Prilosec. So we like the horse and we like the jockey as well.

**Question:**

Are there any areas you're looking for new analysts to cover? Second part: Do you see healthcare as a possibility for an area to invest in?

**Bob Goldfarb:**

With Perrigo, Valeant, and Becton, Dickinson, we have a pretty good position in healthcare. If we could find stocks of more companies like them at the right price, we would buy them. In terms of analyst hiring — David?

**David Poppe:**

We really aren't trying to cover verticals. We're in the item business; we're trying to find really good unusual businesses that we can own for a long time. That requires some mental flexibility from the analysts. A simple example is if we hired someone whose expertise or whose only interest was

insurance, and we go five years without owning anything in insurance, what does that person do? We hire really smart people who can learn and we expose them to some different areas. There is an element of letting people find their own sweet spots, things that they enjoy following or they like to cover where they build up a body of knowledge. But basically we ask everybody to be a generalist because we're not committed to having 10% in healthcare and 15% in financials and 8% in retail. We need people to be able to move around. We like a generalist model, people who can move from idea to idea.

**Question:**

Could you talk about Ritchie Brothers?

**Arman Kline:**

We have owned Ritchie Brothers for a few years now. We took advantage of the stock's dip. The company runs auctions for used construction equipment. Obviously that end market has been pressured and continues to be pressured. While the end market is tough and Ritchie definitely is feeling the impact of that, one thing we have seen is that its competitive position has strengthened. There have been various other models tried for selling used construction equipment. Historically, the business used brokers. But that is more of a regional model; so pricing tends to be very different. The Ritchie Brothers model brought that to first a national then to an international scale. So pricing became more efficient. Some people tried to move to an online only form; that has proven not to work as well as they thought. We're very comfortable with Ritchie's competitive position. We think it has gained market share and continues to be positioned to do well in the future.

**Question:**

I'm looking at all the iPhones and iPads around me here. What do you guys think of Apple and Microsoft?

**David Poppe:**

I think the fair answer is we don't have any deep thoughts on those.

**Bob Goldfarb:**

Lili.

**Lili Ruane:**

Speaking of jockeys, I think we all should congratulate you on the Morningstar award.

**Bob Goldfarb:**

Thank you. Thank you very much. One thing that I can honestly say is the only reason David and I were there was because of all of the other jockeys, our seventeen analysts ... we're not restricted to one jockey on the horse. We've got seventeen jockeys — that was the key.

**David Poppe:**

We were cited really for forty-one years, not for one year, which is nice. But I will throw it back at you — your dad was largely responsible for our being there.

**Question:**

American Express is I believe the third largest position in Berkshire's equity portfolio. I'm wondering if you might comment on your perspective of the risks versus the opportunities that this franchise faces in an environment where — I think the comment was made earlier — that people will be using perhaps exclusively a smart phone to make their purchases rather than a piece of plastic.

**John Harris:**

I don't really know that it's going to have much of an impact. The phone is just a form factor. In other words, how much difference is there between a phone and a card? I suppose a phone can do a few more things than a card can but I don't really know that that's going to impact American Express. It's going to be good for the customer because a card is a piece of plastic — all it can do is be swiped through a terminal at the point of sale. A phone is pretty intelligent because first of all it's got a microprocessor in it. Second of all, it knows where you are. Third, for various reasons it may know some preferences that you have as a consumer. So with the advent of the phone I think card issuers are going to be able to make the experience of using your card more useful for you. They are going to be able to provide you with coupons and offers and discounts that relate to the store that you might be in and your phone may be aware of that.

They certainly are going to be able to give you the power to better regulate your spending on the card or your family's spending on the card. A lot of people frankly have trouble controlling themselves with their credit cards. That is part of the reason that we're in the situation we're in. I suppose if they could give the government one of these things it would really be great. But MasterCard and Visa both have some very slick technology that allows you to

set limits on your ability to spend and get a better idea of how much you are spending in real time and set limits on your kids' spending and so forth. So I think the move to the phone as a form factor will be good for the customer.

I don't really know that it's going to be all that different for the operators of the payment networks. It's pretty clear to me that the model the industry is moving towards is a phone that has a mobile wallet on it. I don't know exactly how it's going to look but there's probably a good chance that the way it's going to look is you press a button on your iPhone or whatever phone you have and it's going to pull up a screen, and you're going to be able to pick whatever option you want. There will be a little icon for your Visa card, an icon for your American Express card. So it's going to be no different than opening your wallet and deciding which card you want to plunk down.

Most importantly, American Express makes money two ways. It makes money from loaning people money and it makes money from processing payments. I'd say that the business of loaning money hasn't changed in God knows how many hundreds of years. It's not likely to change much in the future. The government has regulated the card industry in some ways that make it slightly less profitable than it used to be. But it will be there and companies will find a way to make it a very decent business.

But their business of operating the network — that's a very well-insulated business. I just said I think that Visa and MasterCard's network operations as processors of payments between consumers and banks are very safe. You could make an argument that American Express's are even safer because no one's ever accused American Express of organizing and facilitating a collusive cartel that sets prices in contravention of the Sherman Act. So American Express, because it runs a one party voluntary participation network, is never going to face or is very unlikely to face, anyway, the regulatory risks that the associations face. So I think it should do okay. We don't own the stock, and I don't follow it as closely as I follow Visa and MasterCard. But I don't think there's been a big change for Amex.

**Question:**

I wanted to see if you would be willing to comment — again, I don't want to put anybody in a bad position here — whether or not your firm invests alongside with your clients.

**Bob Goldfarb:**

Yes, I would say that the personal portfolios of everybody here — they might not be as broad as Sequoia because they are not working with as many zeroes as Sequoia has. But they are putting their money where their mouths are.

**David Poppe:**

The basics for insider transactions are that the analysts cannot buy positions until after we have completed buying for Sequoia and the separately managed accounts. And they can't sell until after we have completed selling. If an analyst needs money to buy a house or something, he can sell a stock as long as we are not actively considering doing so. But we buy for our personal accounts after we're complete for our clients, and we sell after we're complete on a sale.

**Jon Brandt:**

Most importantly, if I find a stock that I think I might recommend to Bob and David, and I'm doing work on it — I'm not allowed to buy it for my own account while I'm doing research to convince them. Even if I've decided I like it enough that I want to buy it for myself, I can't until they decide not to buy it. If they decide to buy it, I am restricted as David outlined.

**Question:**

Certainly the domestic issues that you talked about are all very real and valid. But there is one silver lining in the world and that is there are probably more capitalists in the world than there ever have been. Capitalism has been a great way to create wealth over time. Just look at what's happening in China, Brazil, hopefully the Middle East at some point. Certainly you have a fair amount of exposure to that in a growing middle class. The question is do you think you have enough exposure?

**Bob Goldfarb:**

I think as David indicated earlier, as long as the company is selling at a price that's reasonable with respect to its profitability and growth rate we're interested. It would have been a big mistake to have passed on Valeant because it didn't have a lot of business in China or India, as an example. So we're finding plenty of ideas. But we're aware of the trends that you're acknowledging and we certainly do factor them in when we look at an individual company for consideration for purchase.

**Question:**

What is the future of the S&P 500 Index as a relevant measure of stock performance in the context of the value of the US dollar and the prospects for inflation?

**Greg Alexander:**

What Warren said at the meeting, Jonny, the dollar from the 1930s till today is only worth —

**David Poppe:**

Six cents.

**Greg Alexander:**

It's down 94%. But the economy has gone on. The S&P, I guess you could have adjusted it for inflation. I don't have that. That six cents kind of tells the story, the dollar is down by 94% but we're still all here.

**Bob Goldfarb:**

But we're a lot more prosperous in real terms despite that decline in the dollar.

**Greg Alexander:**

It's good to own businesses or things that retain their value as the dollar gets debased.

**Bob Goldfarb:**

Most of our companies — if you go back to Warren's seminal article in *Fortune*, "How Inflation Swindles the Equity Investor," we think the great majority of the stocks that we own fit that bill perfectly.

**Greg Alexander:**

I will add that when people talk about inflation they often talk as if they should buy gold or resources or whatever. We think good businesses are just as good.

**Bob Goldfarb:**

The answer is that the S&P 500 will continue to be Sequoia's benchmark. You should note that nearly half of the S&P 500's earnings emanate from outside the US.

**Question:**

I have a question about Buffett's succession. A number of times I've seen on the news outlets when

Charlie and Warren appear, Bill Gates is there. Is Gates a possible successor?

**Bob Goldfarb:**

I would think if Bill Gates wanted to be a CEO, he would have remained at Microsoft. But he's clearly decided to devote much of his life to philanthropy. Given the size of the Gates/Buffett foundation and the dedication that he and Melinda have to it, I don't see that happening.

**Question:**

He just seems so comparatively capable.

**Bob Goldfarb:**

His primary interest is in philanthropy.

**Question:**

Could you quickly comment on the challenge that the next CEO of Berkshire will face in terms of capital allocation? With all the cash being generated by those businesses and when I look at the billions of dollars of deals that Warren's done, I have a hard time seeing someone else in that seat being able to get those deals done.

**Bob Goldfarb:**

It's an enormous challenge when you're working with that sum of money and you're generating that much cash every year. That person is going to have his hands full. And to follow a CEO as great as Warren, wow, those are big shoes.

**Question:**

The issue of the next CEO having big shoes to fill ... are you entirely comfortable with how it will play out over decades?

**Bob Goldfarb:**

Not entirely.

**Jon Brandt:**

I'm not fully disagreeing with Bob. But I think Berkshire will start deploying cash as dividends, share repurchases, or some combination of the two after Warren is no longer CEO. So that will reduce the size of the job for the successor in some respects.

**Bob Goldfarb:**

That ends the Q&A and we thank you all for attending. We look forward to seeing you next year.

