Ruane, Cunniff & Goldfarb Investor Day

May 14, 2010 – St. Regis Hotel, New York City

The following is a transcript of the question and answer session of our recent Investor Day. The remarks have been edited for clarity.

Bob Goldfarb:

Good morning and welcome to our investor day.

Before we begin taking your questions I'd like to introduce our team. On my far left on the dais is Greg Steinmetz. Next to Greg is Jon Brandt. Next to Jon is David Poppe, who is president of our firm and co-manager of Sequoia. To my left is Rick Cunniff, whom many of you know and who 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.

Finally, I'd like to introduce the rest of our team who are seated in the front of the room on my left and to your right. In alphabetical order they are Vish Arya, Girish Bhakoo, John Harris, Jake Hennemuth, Arman Kline, Trevor Magyar, Terence Paré, Rory Priday, Chase Sheridan, and Michael Sloyer. Stephan van der Mersch and Scott O'Connell are unable to be with us today but we hope they are present next year. I'd also like to introduce Jon Gross, who is our director of client services. We're now ready to take your questions.

Question:

This is a question for you, Mr. Goldfarb. Last year, you expressed concerns in your prepared remarks about the potential for a US currency crisis. Considering the crisis that is developing in Europe, I'm wondering if you had any further comments on that at this time.

Bob Goldfarb:

I think the risk still exists. The difficulty is predicting when. I'm not sure that six months ago many people were predicting the decline in the euro that we've seen in recent weeks. But if we continue to run large structural deficits, ultimately I think the easiest choice is to inflate and devalue the currency. If I had to bet, I would wager that the structural deficits in the United States will continue at a pretty good pace as a percentage of GDP.

The good news is that the public seems to be very concerned about these structural deficits, but whether that will result in a significant reduction of them … I'm dubious. It's very easy to be against running up large national debt and these deficits when you don't have to pay for it. But when your ox is gored, as they say, people are a lot less inclined to take the hard road that's necessary to address the structural deficits. We're seeing that playing out among the municipalities and some of the states that are struggling with large deficits. You see it in California; we'll probably see it in New York next year.

New Jersey is an interesting example. At the present time, Governor Christie is trying to address very large deficits, and you can see the kind of opposition that he's running into. Getting people to volunteer to pay their share or take the pain in order to get our fiscal house in order is an enormous challenge. I don't think we're there yet. Greg?

Greg Alexander:

We could go on about this all day. But I don't think the solution to a debt crisis is to add a lot of debt.

Bob Goldfarb:

You should have asked Greg the question. You would have gotten a more concise answer.

Question:

I have a much easier question. It's on your auto parts retailing companies and it's in three parts. One, on the auto parts retailers, why do you like the industry? Two, why do you own the ones that you do? And three, why do you not own AutoZone — at least it's not in the Fund — which is the largest in the industry?

Rory Priday:

The auto parts business is inherently a good business. You can see it especially on the retail side. I'm not sure if many of you have ever walked into an auto parts store — presumably a lot of you have — but you probably don't know how much it would cost to buy an auto part. So there is a little bit of pricing power. It's a good business when the customer doesn't know how much the part should cost. It's a little less so on the commercial side. They are selling to the garages, and obviously the garages are buying brake parts or carburetors every day; so they know what the price should be. But it's a good business.

The returns on capital are fairly high and it is actually growing in this environment. It's done particularly well the last two years — comparable store sales across the industry have probably been up about 4-5 percent. Previously they were comping at maybe only 1-2 percent if that. They were sort of flat. But it's a good business; it's growing. Not a lot of things are growing right now. And the returns on capital are high.

I guess the more interesting question is why we own both Advance and O'Reilly. The reason we own O'Reilly is obvious — it's the best commercial player in the business. The reason is that it has greater distribution than other companies in the sector. If you think about auto parts, it's like going to a physician's office; it's sort of like the healthcare industry. When you go into a parts store, you're there for a reason — you're not shopping around — you're going to buy a part or you want to buy a part. So the key is to have the part in the store when you get there.

The reason that O'Reilly is the best in the business is that it has on a per square foot basis the greatest amount of distribution power relative to Advance and AutoZone. By the end of this year it is going to have 23 distribution centers. Advance has eight and AutoZone is pretty close to that. So O'Reilly has greater distribution. That's why we own it — it has an advantage there. Because it has to invest in that distribution system, the returns on capital are a little bit lower than they would otherwise be.

Then the big question is why we own Advance. We knew it was an inherently good business. We knew the business well. They brought in a management team led by Darren Jackson from Best Buy, which is very good. Jackson saw what was wrong with Advance and that management could do certain things to bring its performance up to what you would call industry average. If management just does that, not assuming that it does anything beyond that, then we should do pretty well given the price that we paid. So that's why we own Advance. What was the third question?

Question:

Just a comment on AutoZone — it is the biggest in the industry and I noticed you didn't own it.

Rory Priday:

It was very close with regard to that question in terms of AutoZone and Advance. At the time we were looking at the companies, they both seemed cheap. Basically, when looking at Advance, we thought there was a little more ability for it to buy back stock for various reasons — part of it was that it didn't have as much debt as AutoZone, and part of it had to do with Advance's potential to push accounts payable out.

If you look at AutoZone's accounts payable to inventory — I'm going into too much detail here — but it's relatively high and Advance's ratio is relatively low. So Advance can create an incremental say $350 million in cash flow if it pushes it out a little bit over the next 3-4 years. Management is going to be able to buy back more stock with that cash. So that is why we thought it was a little bit better than AutoZone. That being said, we also liked AutoZone at the time, just not nearly as much, and we decided to pick one.

Bob Goldfarb:

We have enormous respect for AutoZone. We did own it several years ago and made the mistake of selling it. There were two reasons for our sale. One was that we were not big fans of the CEO. It turned out that Eddie Lampert, who controls AutoZone, was also not a big fan of that CEO, and he soon departed and went on to do some serious damage at Office Depot.

The second reason why we sold AutoZone is we were concerned that it was being milked — that it was cutting not just fat but cutting muscle. Generally we're not big fans of companies that maximize their earnings by milking. There is a fine line and I have to say at the end of the day we were wrong. The business has continued to prosper. AutoZone is, without question, the leader in the do-it-yourself space.

It's interesting because when Darren Jackson came to Advance, Advance had been primarily in the DIY space. It was a definite number two to AutoZone.

Jackson thought that it would be more profitable for Advance to try to emulate O'Reilly with its hybrid model of 50 percent DIY and 50 percent do-it-for-me. But if you own AutoZone, you ought to keep it and you might find us as shareholders at some point in the future.

Greg Alexander:

The questioner well knows this but just for the general audience, AutoZone has bought back two thirds of its shares in less than ten years. I don't know who's bought back more than that. Henry Singleton's Teledyne maybe bought back 80 percent or more back in the '70s, but is there anyone else? It's kind of amazing.

Bob Goldfarb:

No, that's why it has the debt that Rory was referring to. The business itself is highly cash generating and the only reason that it has the debt is that it borrowed to buy back stock and it's worked wonders.

Question:

I wonder if you could talk a little bit about Martin Marietta. Back in 2008 before the financial crisis hit, Martin Marietta was buying back stock at well over $100 a share. After the financial crisis hit, it was issuing stock at $80 a share.

Bob Goldfarb:

I'd preface our response by saying that we no longer own Martin Marietta. We definitely bought it too high and we may have sold it too low. Only time will tell. Chase?

Chase Sheridan:

When a lot of managements buy back stock, they tend to do it when they are flush. They tend to be flush with cash at the top of their cycles. So it's not always the best idea. We weren't happy about the capital management per se. That wasn't the fundamental reason we sold the stock. There were two things that worried me the most about Martin Marietta.

One is 55 percent of its sales are derived from infrastructure spending, and we don't have the money in this country right now at the federal, state or local level to maintain our infrastructure properly. The onset of the great recession has prompted an era of trillion dollar-plus federal deficits and we're seeing the strain in terms of financing. The Highway Trust Fund was actually shut down on March 1st until Congress approved stopgap funding legislation. I don't know when Congress will find a longer-term solution to the financial problems of the Trust Fund, but I do know it will be a struggle to find the money. So public infrastructure spending was a worry.

The other issue I have is that with a 40 percent peak-to-trough decline in aggregate volumes from 2005 to 2009, this is an industry that is in a state of overcapacity. We originally bought Martin Marietta in part because we saw that it had tremendous pricing power. It's interesting that even with a 40 percent decline, the average ton of rock sold by Martin Marietta was under $9 in 2005 and it was near $11 in 2009. So they actually increased price over that time period. However, in any industry when you have a surplus of productive capacity, pricing becomes more difficult. The aggregate industry could increase production of rock by 50 percent in very short order if the demand were there. In that situation, if you want to put a time on it, price lags volume, typically in this industry by about one year. Last year was a terrible year for the industry and this year won't be much better in terms of volumes. I anticipate an extended recovery for the aggregate industry as a whole. So it wasn't necessarily anything specific to Martin Marietta — although management didn't make the best decisions with its capital; it was actually better than some other public companies in the space.

As you may know, there were a number of acquisitions at very high multiples at the top of the market. Martin Marietta at least refrained from that; so it is not among the most guilty. It wasn't a management specific decision, at least in my mind, for why we sold the stock. It was more about the structure of the industry with volumes off as much as they are.

Bob Goldfarb:

Chase, how much did Martin Marietta produce at the peak?

Chase Sheridan:

About 203,000 tons of rock, and now it's in the 120s.

Bob Goldfarb:

What do you think that 120 will get to?

Chase Sheridan:

I think a normalized level of production would be something around 160,000 tons of rock but I couldn't really tell you how long it will take to get back to a normalized level of production.

Bob Goldfarb:

That's the basic reason we sold it. Clearly there will be some price increases but if you put in some volume assumptions together with some price increase assumptions, you certainly don't get an earnings number that would justify the price we paid. Whether it justifies the price we sold it at — we will see.

Question:

Can you talk about Porsche, where it is and what you see and what are you thinking of doing with it if anything over the next year or so?

David Poppe:

As everybody knows, and as we talked about last year, Porsche has been a disaster. It's a much smaller part of Sequoia today than it was even at the end of the year. We have reduced the size of the position.

I'll try to keep it short, but we bought Porsche because it's one of the great luxury brand names in the world. It is the highest operating margin car company in the world. We felt, and I think accurately, that management had a great opportunity to grow the business. In the emerging world it's a very powerful status symbol, but it's also a very good product that you can use, unlike a Ferrari or a Lamborghini. We bought it for economic reasons. I think we got a lot of things right.

The entire Volkswagen merger was a disaster for us. It really comes down to this: Porsche ultimately — to make a long story really short — got over-leveraged, found itself in a pinch, and was not able to refinance the options that it had bought on Volkswagen, and ended up having to sell the business to Volkswagen. Porsche had already sold half of the car business to Volkswagen for a very low price compared to the value of the company. The family that owns 100 percent of the voting stock decided to do that for reasons that we will always find mysterious. They are not clearly economic reasons. The family will end up with a large ownership position in Volkswagen, but it will have traded 100 percent interest in a tremendous asset for a much smaller interest in a good mass production car company.

As a Porsche owner today, you really don't have a direct interest in the economics of the Porsche car business. You have a look-through interest into shares of Volkswagen that Porsche owns and some debt that Porsche accumulated to buy those shares. So the Porsche stock should really trade as a look-through to the Volkswagen stock. But because the final terms of the merger are still so murky, at least to us, it's not even clear to us that you deserve to get the look-through interest from the Volkswagen shares because you don't know what the final terms will be.

Therefore, you can't really make a strong economic argument to own Porsche, because there is no earnings factor or return on capital factor that will drive the Porsche share price. There is simply what happens with Volkswagen and what happens with this merger. The merger is not supposed to be finalized until 2011; so it's more than a year away and it's still very unclear what it will look like. Our shares in Porsche and your shares in Porsche have no voting interest; so we have really no power, no say into what happens. It's strictly a decision of the Porsche and Piëch families, what they want to do. Therefore, I don't think you can really justify owning it in Sequoia Fund. We've been getting out of it but we're not completely out of it. Porsche trades at an incredible discount even to its look-through interests in Volkswagen. So you're really capitulating and that's painful. We've tried to avoid that but every day gets a little worse than the day before.

Greg Alexander:

It's a real testimony to the dangers of hubris. Management seized defeat from the jaws of victory. It did a brilliant job of turning around Porsche, making the product great. The doors close so firmly, you can't hear the outside noise. There is no clank. People are buying them. And it bought a large amount of

Volkswagen right at the bottom of the cycle — brilliant idea.

Then management got carried away. It's just an example of a good idea taken to its disastrous extreme. Why didn't Porsche just stop when it had a quarter of Volkswagen? Porsche had no debt; it would have been a triple in the stock. What's wrong with that?

David Poppe:

The original idea — probably many of you know and it was our impression — was that Porsche had a problem with a lack of factory capacity and Volkswagen had excess capacity. Porsche really wanted to force industrial cooperation on Volkswagen. So the idea was, "We'll buy 25 or 35 percent of the Volkswagen shares," which were trading at incredibly low levels at that time. "And we'll have some influence and we'll be able to do deals where we can utilize that excess factory capacity that Volkswagen has."

That made sense, and Porsche could do that without accumulating a lot of debt. But to go to 75 percent — first of all, as the company accumulated more of it, the Volkswagen share price went up and up and up. So to accumulate 75 percent broke Porsche's back. Why management felt it needed to do that and why when it became clear that the company wasn't going to be able to finance it, management didn't unwind it and chose instead to capitulate and sell its own business to Volkswagen is one of the great mysteries that I don't think we'll ever understand.

Question:

Bob, you've made a number of commitments lately in foreign stocks. Do you feel qualified to make those commitments? Do people travel overseas? Do you have a feel for the macro situation, say in England? It's different from anything that I've known you to do in the past.

Bob Goldfarb:

We've owned foreign securities in the past. We own them in a greater percentage today, but they are still a distinct minority of the portfolio. We do have a pretty good knowledge of those companies' business, their competitive dynamics, their managements — except for Porsche, of course.

The biggest problem for us has been currency. We've done a lot better in local currency than we have in dollars. So, with the exception of Porsche, to the extent that we have losses in foreign securities, they are a function of currency. We have no greater ability to predict where currency is going to be than anyone else does. But it's a very good point you raise and we've clearly been thinking about it ourselves. It leads us to conclude that we should seek a discount for a foreign security relative to what we'd pay for a comparable business that was domiciled in the United States.

Question:

What is the next stage in the Omnicom situation?

David Poppe:

Probably most of you saw the letter that we wrote. I'm not sure there is a next stage for us. I don't think we're really well-equipped to become activists and try to force some kind of change there. Frankly, it's a done deal. We couldn't force a change anyway. We have to make a decision about what our tolerance for that kind of behavior is.

If you didn't see the letter — we filed a mild protest and we were going to vote against the reelection to the board of the compensation committee of Omnicom. The company granted 26 million shares of options in late 2008 and early 2009 to the employees, and that is about 8 percent potential ownership of the business. We felt it was egregious.

I don't think there is any realistic chance to force change. I will say management did engage us in a pretty open dialogue, but it believes strongly what it did was right — that these options would have a strong retention power so long as the economy was very, very weak. But obviously at a very, very high price to shareholders. The options are already, one year later, in the money by more than $400 million. Omnicom is a very good business and it could eventually be a billion dollars of wealth that's transferred to the employees.

The short answer is we're unhappy about it. We have to make our own determination about what our tolerance for this behavior is. But I don't believe you're going to see us taking this to another level of protest. We said our piece and the management there knows how we feel about it. It knows very well how we feel about it.

Question:

I'd be interested in hearing about your feelings about Mohawk, which is pretty much related to home construction, which obviously has been down but seems to be coming back.

Terence Paré:

Mohawk, to quickly review, makes floor covering. It's the largest floor covering manufacturer in the world. Its businesses are dependent to a degree on new home construction but most of its business — roughly two thirds of it — comes from remodeling. That's more dependent on existing home sales and the general economic climate.

As far as new construction of homes is concerned, we're starting to see a little bit of a recovery in that this year, thanks in large part to help from the homebuyer's tax credit. Sales are up a little bit, construction is up a little bit. Existing home sales have been ticking upward as well. So there is a pretty good — not a vigorous — but a substantial enough tail wind on the residential side of the business. So we'll see some recovery there.

The other piece of Mohawk's business depends on commercial construction and that unfortunately is going to be pretty weak this year. So the company is going to suffer a little bit from that, but the strength in the recovery on the residential side is sufficient enough that I think we'll be okay.

There are a couple other aspects to the business that will come into play during the recovery that are worth mentioning. One is that during the housing boom, Mohawk and most other suppliers of building materials ran every factory they had for as long as they could to make money while the sun was shining. The good part about that is that you make the money. The unfortunate part about it is that you tend not to be as efficient in your manufacturing as you could be. You'll run plants that have dated equipment and that aren't really all that efficient. During the downturn, the company has done a very good job of taking the least productive assets that it had out of commission very quickly. So the manufacturing base it has right now is much more efficient on the whole than it was during the boom.

The second aspect to keep in mind about the business is that management has also been very judicious in how it has invested the cash that the company has continued to generate during the downturn. The silver lining to the bad market for floor covering is that Mohawk has been able to pay down debt while its sales were cratering because its working capital needs were shrinking too. So the company is actually less leveraged now than it was during the downturn because management has done sensible things with the cash. So there is that aspect of it.

One other piece to keep in mind is that Mohawk, almost alone among the floor covering manufacturers, has been willing and able to invest in new products. We know the housing business isn't going to grow at a tremendous rate, but if you can create a product that captures some of the revenue from the installation part of the business, you can generate a little bit faster growth in your sales than you would otherwise. For instance — this is just one example — the company is now experimenting with a form of ceramic tile that you snap together and that doesn't require grout. That's more DIY information than most people will want, but the fact is if you pay a dollar for a piece of ceramic tile, it's going to cost you $5 to get it installed. So the installation market is roughly five times the size of the material market. If you can create a product that captures some of the installation revenue, suddenly your market can grow faster than the underlying material market can. Management is doing other clever things like that to generate a little incremental growth when the recovery gets a little bit stronger.

So overall, Mohawk came through the downturn. It has a raft of new products coming to market. The housing business is what it is. The population in the United States grows. Households will have to be formed, and over the long run I think we will be okay.

Bob Goldfarb:

The other thing I'd emphasize that Terence said is that Mohawk has taken — like a lot of other American companies — a lot of cost out of its business. We don't believe that revenues in the next cycle have to be equal to or greater than revenues in the last cycle for Mohawk to earn as much as it did in the last cycle. So that's why we're holding the stock and we think we'll do pretty well with it.

Question:

We're sitting here with the portfolio holdings from the end of last year. And you've now told us about three major sales — of Berkshire Hathaway, Martin Marietta and Porsche — I don't know how many people here consider this to be inside baseball. Can you tell me what percentage you now hold of those three investments, and what you have done with the proceeds?

David Poppe:

On December 31, 2009, we were 16 percent, roughly, in cash, and we're about 20 percent in cash now. So there is about 4 percent net that's in cash. We have made a number of investments in 2010. Probably 10 percent of the portfolio is in new investments, subsequent to January 1, 2010. We're not going to chat about those today. In some cases we're still active buying stocks; so I just think it's a better policy to talk about what you own at year end. But it's not all gone to cash, we're about 20 percent in cash today.

Question:

What percentage of Sequoia is in Berkshire?

David Poppe:

Berkshire is about 14 percent of Sequoia. We should have mentioned that. That's a good question. Berkshire was 20 percent of Sequoia at the end of the year. Martin Marietta, we're out of. Porsche is a little under two. But Porsche is partly sales and partly just Porsche going down every day.

Question:

I had a question about the new holding, Becton, Dickinson. I remember 16 years ago you owned J&J and I was wondering why you chose Becton instead of J&J, Abbott Labs, or Medtronic, for instance. Do you see a better competitive advantage or perhaps a better management team?

Vish Arya:

Becton, Dickinson, for those of you who don't know, is the world's largest manufacturer of medical needles and syringes. That's the bulk of its profits. Becton also makes medical diagnostic instruments and tools and instruments for researchers.

The company's cost structure is such that it is very difficult for competitors to sell a comparable product for less. In fact, they can't, really. So there is a very strong competitive advantage from a cost manufacturing standpoint. There are good growth prospects as well and growth is really coming in two ways. You have growth through volumes in emerging markets, where increasing healthcare standards are leading to more patients being treated. When you have more patients you have more injections, more IV's; so you have growth from a volume standpoint.

You also have growth from trading up. What Becton, Dickinson has done is innovate in the safety aspect of their products. About a decade ago, there were a number of issues relating to accidental needle-stick injuries. Healthcare workers delivered injections and they accidentally pricked themselves. There were some high profile cases where healthcare workers might have ended up contracting a disease, AIDS or something of that nature. So Becton, Dickinson made a number of innovations. It created preventative devices to help avoid injuries. For the added value, Becton can charge more. The company has continued to release innovative products to encourage trading up.

Bob Goldfarb:

In terms of comparing it with J&J or Medtronic, both of which are terrific companies, Becton, Dickinson has a couple of advantages. One is it's a much simpler business to get your hands around than either of the others. The second is that because its core business is small ticket items, Becton, Dickinson is less subject to reimbursement risk than Johnson & Johnson may be in some of its divisions and certainly Medtronic would be as well.

Question:

One of the reasons I came to the meeting here today was find out about QinetiQ

Arman Kline:

QinetiQ is a UK defense contractor that has business in the US as well, but it's based in the UK. It's been struggling of late. It's essentially a spin-out of the UK Ministry of Defense's R&D division. For example, QinetiQ invented robots that soldiers can carry on their backs and that can defuse mines or do surveillance. It is also developing a product that uses solar energy and can stay up in the sky and do reconnaissance for months and months and months. It also runs certain munitions fields in the UK for the Ministry of Defense.

The previous management did not run it well and the board brought a new CEO in. We happened to know that CEO — he used to run De La Rue, which is a money printing business that we own. We think very highly of him. He is now turning QinetiQ around. We are confident that he will succeed in doing that, and we think there is money to be made as a result.

Question:

Two questions. One is why did you take such a small position in Verisk and Mettler. My last question is — it wouldn't be a Sequoia meeting if Jonathan didn't tell us about the Berkshire meeting and how he played poker with Warren.

Bob Goldfarb:

Certainly. In the case of Verisk, we put in an order for a lot of shares on the initial public offering. But we were allocated very few. The stock ran up immediately on the following day. So that accounts for the size of the position. Mettler Toledo — we wanted to buy a lot more stock. We were buying it as the market was bottoming but we didn't have any knowledge that it was bottoming. So we had a price limit that prevented us from buying more shares. But it's a company we admire and hopefully we'll have an opportunity to add to the position.

Question:

If I could follow up on that, what you're saying with Verisk then is you're not buying anymore. Why? Because you don't think it's going to go up very much more? I just don't understand the philosophy. If you think it's going to hit $100, then why not buy it where it is now? And the same thing with Mettler.

David Poppe:

Your point is a really good one. In general, though, I can remember with Martin Marietta working out all sorts of models how it was easily going to be $200 — and your price discipline saves you from yourself when you get things wrong — you just really have to have price discipline. That means sometimes you miss things. If you look at your Sequoia sheet, you'll find stocks that are 0.1, 0.2, 0.3. In almost every case if not every single case including Costco, which has been on there for ten years, we had a price that we wanted to pay and we got that price for a nanosecond. We bought a little bit of stock. We're a big firm, it's hard to fill positions in a day or two. The stocks ran away from us, and we stuck with our price discipline. The Martin Marietta lesson, where we did chase it a little bit and we got a lot of things wrong — we got the economy wrong — hurts a lot. At the end of the day, if you don't have price discipline more things will go wrong for you than will go right.

Question:

But again, take Costco. If you don't think it's going anywhere then why are you holding it?

David Poppe:

It's funny, we like Costco, we think the business is fine. As I said before, I think you have to allow for the possibility of being wrong. In the case of Costco we were right. Costco is a terrific business. Sometimes you own them because you think — if I own it, I follow it. If I follow it, I'm thinking about it and one day it will get to my price and I will own more of it.

In the case of Costco, it's a teeny position but it's still probably close to a million shares across all the different accounts. You can go to management and have a dialogue with management because you own a lot of shares. Even though it's absolutely teeny in the context of the overall firm that we run. So there are different reasons to hold them. The main reason to hold them is that we like them, and the main reason not to own more of them is in a weird way we're humble. We think it was worth this price. We'd think we'd make a good return at this price, we think we might make an okay return at a higher price. Typically we're trying to earn better than okay returns.

Bob Goldfarb:

Jonny, you're up.

Jon Brandt:

One of my frustrations with the Berkshire meeting is that even with the new format where journalists sift through half the questions and choose the ones that they think are most interesting, I still would say that less than 15 percent of the questions apply directly to the business as a shareholder or a security analyst following it would want them to — the types of questions that I'd be interested in having answered as a shareholder of Berkshire. So I would say it's 90 percent circus and 10 percent useful information. A lot of budding money managers ask questions about inflation or currency or macroeconomics. It's all interesting stuff and Warren Buffett is a genius, and I'm curious about his thoughts on a wide range of topics. But inasmuch as it relates to the company itself, there are only little snippets here and there.

The two headline topics this year at the meeting were the Goldman SEC suit because Berkshire owns a preferred and warrants to convert into common stock, and also the legislation about potentially putting up collateral for derivatives contracts. It was pretty widely reported in the press that Warren defended Goldman. I personally thought Warren made an excellent argument. And he said that the legislation as presently drafted would not require him to put up any collateral on the derivatives contracts. Even if the legislation did, I don't think that would be something we should be worried about. He may have to create some liquidity somewhere else, but I don't see why he couldn't put Coca-Cola up as collateral if the final bill were to require some collateral on the equity put contracts.

As far as what I got out of the meeting, I got a real sense — and he's on TV also so much more often than he used to be — so every couple weeks you seem to get an update of what he's thinking and how business is. But the main thing I got out of the meeting was that a lot of the businesses — and some of this came from his interviews before and after the meeting that were on TV or in the press — that the economically sensitive businesses are getting stronger right now.

Iscar, TTI, NetJets — he didn't talk that much about them at the meeting. But NetJets went from a \$15 million loss last year to a \$57 million profit in the first quarter. It's not a huge unit for Berkshire but it's symbolically important if for no other reason than that David Sokol is running it and he seems to have done a good job so far. He had projected to break even this year hopefully, and it looks like at the rate of the first quarter it might make \$200 million. The economically sensitive businesses are stronger but that doesn't necessarily raise my intrinsic value of the company.

Question:

How do you get comfortable with the valuation of Fastenal?

Chase Sheridan:

I think that's a good question and it's a timely question. Fastenal is trading at a very high multiple right now. I ask myself that question quite often because when you look at Fastenal in comparison to some of the opportunities out there, you have to have a lot of confidence that Fastenal is going to continue to grow not just for a long time but at a fairly quick clip to justify its current valuation. Part of it comes from knowing the company very well and from knowing the management. Management is extremely transparent.

Because management is extremely transparent, we get a good view into where the company is going to be able to leverage revenue growth to the bottom line. I was in Indianapolis recently for Fastenal's customer show and spoke with top management. You can see places in the company where there are still great opportunities to save money to lever any growth that it gets. The company is adding active accounts very rapidly. Interestingly enough Fastenal has added accounts even as sales plummeted in 2009 throughout the entire recession, which tells me that the magic is still there in terms of the company's culture and its competitive advantages.

But just to give you a feel for the numbers — I do run hard numbers; I'm not going to put out a projection today — but just chatting with the CEO, he will tell you that he thinks that using his current store base Fastenal should be able to do $4 billion a year of sales easily, without opening another store. Now, that's obviously not going to happen — it is going to continue to open stores. Fastenal is $2 billion in sales today; so you can imagine the leverage that you get if you double the volume going through that system.

Meanwhile if you look at its distribution hubs, Fastenal has a pretty wide variation of performance among the distribution hubs, and it is a company that is very, very good at taking its best performing models and applying them across the company. It is continuously improving all the time. It is kind of an amazing statistic, but the Winona distribution hub operates at half the cost of the company's other hubs, and it's the people who are responsible for that. It's the fact that Winona has no turnover and that it is staffed with employees with a longer tenure at the company.

So I very much understand the sentiment that Fastenal is extremely expensive; you have to have a lot of faith. I think you have to have faith that the company is going to meet its 23 percent operating margin target and do so in a relatively short amount of time.

One thing you can do is look at how margins for a typical store age over time. You can see that it doesn't take a lot of effort; it really just takes the aging of the store base in a normalized economy for margins to increase at a pace of about one percent a year. But of course Fastenal tends to do better than that over time because of the amount of effort it puts into the business.

An interesting example — the company recently introduced vending machines, which was an old idea. Fastenal is selling industrial equipment through vending machines to its customers. This allows the customers to track the usage of these items — dust masks, surgical gloves, whatever it happens to be. It reduces consumption of these items, but it also allows Fastenal to control what goes into the vending machine a little bit better. They are usually higher margin products, and the machines tend to make a customer much stickier. Fastenal has sold about a thousand of these vending machines. It is selling them at a rate of about 100 a month. I asked the CEO, "Where do you think you can get on these vending machines? Because you were awfully pie in the sky the last time I talked to you. You said you could sell 10,000 of these things." He gave me a number that was much higher. The potential that management sees is very high. It's an incredible management team.

So we do see the opportunities for growth. I think we'll see the effects of the recovery in the bottom line this year. You can see it in the consensus projections that the rest of Wall Street is giving the company as well. There is a lot of optimism around this company and it is going to grow its bottom line from admittedly very depressed levels, but very quickly this year and it should continue as the recovery continues. But these are not typical margins and typical earnings levels for Fastenal. I think they earned $1.24 in 2009. The multiple is a little misleading right now.

Question:

TJX is your second largest holding. Why are you so enthusiastic about it?

David Poppe:

Because it goes up every day. TJX is a really exceptional business. The last few years with Carol Meyrowitz as CEO, we think it's actually been an extremely well-managed business. We did not have any sense coming into this economic turmoil that it would perform as well as it has. So we can't take credit for that. But I would say generally the model that it has of buying surplus apparel and household accessories in a marketplace that is perpetually overloaded with surplus, where the barriers to entry are very, very low, where anyone can produce apparel and go into business — that's a really good model.

TJX is not planning assortments nine months in advance like a department store. Management is able to respond very quickly to trends it sees in the marketplace. The company happens to exist in a marketplace that is fundamentally irrational because the barriers to entry, again, to get into apparel are so low. TJX is now — I haven't looked at Macy's in awhile — but it may be larger at this point or very, very close to being so. Macy's may still be a little bit bigger. Yet, there is no shortage of things for TJX to buy. It's a terrific model, it's a very good management team. It's one of the few areas in retail right now where management is talking about 5-6 percent square footage growth for the next few years. It is able to take advantage of a really distressed real estate market when most other retailers, including great retailers like Target, are curtailing their expansion.

So you've got better growth prospects, you've got a fundamentally better model that takes advantage of some structural flaws in the way the apparel industry works. It's not very expensive. It's been a very, very good performing stock. But really the stock has moved with the earnings so even today it's 13-13.5 times the 2010 estimate. With a billion dollars of net cash and a strong commitment to buying back stock, it just seems like — at a minimum — a very good hold for us right here. We've owned it for 10 years and I think the stock has compounded in the mid to high teens over 10 years and yet the earnings per share have compounded in the mid teens over 10 years.

I don't expect that if the economy becomes robust in the future people will continue to trade down from department stores and specialty stores to off-price stores. But I will say that TJX has tended to do a really good job over a long period of time of holding the customers that try the stores. That should also give you some optimism that the future ought to be at least decent.

Question:

I'd like to know your thoughts on gold and energy. I'm looking at the portfolio of some other value managers out in L.A. here and I see that their allocation to energy is about 38 percent and yours is pretty much zero. I'm curious to know what you guys think.

Chase Sheridan:

Generally speaking I would agree with Buffett's comments about gold. You take the yellow metal out of the ground and then you put it to industrial uses or jewelry and then often you put it back into the ground. So it becomes a sentiment bet. You are making a macro bet on the level of worldwide confidence in fiat currency.

To me it just doesn't make any sense. You don't get a yield. If you are really worried about inflation risk, there are ways to hedge inflation risk where you still get a reasonable yield. You might look at timber, you might look at oil companies. But one very good way I think to hedge inflation risk is to invest in excellent companies that have pricing power. You get yield from that; so I don't really see a reason to buy gold when you can invest in a business that leverages the creativity of people and gives you an earnings yield at the same time.

Bob Goldfarb:

I'd add that I think the people who are buying the gold are making a macro bet and they may well be right. But we haven't done that well making macro bets; so we probably are going to stay away from it.

Greg Alexander:

On energy I'd give the same answer I gave a few years ago. Which is it's a good business; we spend time on it. At least three or four people here have written internal reports on energy companies within the last six months. There are some wonderful companies. We own a few shares of Canadian National Resources, which is a very smart company run out of Canada by Murray Edwards. But in general we don't know what the price is going to be of oil and gas. So sort of like with gold, we just don't know what the price will be, we don't really know how to forecast it. So there tend to be people who have firmer opinions than we do about what the price of oil and gas will be. Therefore, they end up being willing to pay more for the shares than we are.

There is a good saying in the oil and gas business that the cure for high prices is high prices, and the cure for low prices is low prices. So for example at the moment no one is interested in gas because the price is so low. But the fact is the gas supply goes down 25 percent in one year in the United States if there is no drilling. So if people would just stop drilling, any supply and demand problem that you could think of would be quickly corrected.

Bob Goldfarb:

One thing I'd add is that some of the oil price is driven by speculators rather than by natural demand of energy users. I'm just more comfortable with a price of a commodity that is set by market forces and doesn't have that speculative component that both oil and gold have.

Question:

My question is really about the philosophy of investing in the fund moving forward. Recovery doesn't mean recovered — There has been a lot of comments around that. And there has been a lot of talk about the business cycle becoming a lot more volatile and recessions becoming more frequent. Does that change your thoughts on the portfolio in terms of making long term bets on the companies that you've been investing in?

Bob Goldfarb:

I would say that a number of the changes in the composition of the portfolio have reduced our exposure to the economic cycle. Martin Marietta would be a good example of that. So we're less exposed. I have to say I think most companies have been stress-tested in the last couple of years in terms of their vulnerability to difficult economic circumstances and declines in demand. So we've addressed that in part by reducing our cyclical exposure. The dilemma for us today — and the previous question I think I addressed this — is it's possible that the next cycle could be more about inflation and less about weak demand.

There are some investors whom I admire out there who have made huge bets on inflation. I suppose if we had a very, very strong conviction about inflation we might have kept some or all of our Martin Marietta, as an example. So I think we're pretty well protected against the kind of decline in aggregate demand that we've seen. Hopefully our protection against inflation, as mentioned earlier, is owning terrific businesses with high cash generation.

Greg Alexander:

We haven't changed our thoughts about debt. In general we just don't like companies that have a lot of debt. We don't think people should have a lot of debt personally. We don't really like companies that have a lot of debt. Frankly, whenever clients or companies ask us about it we say that we can think of a lot of people and a lot of companies that get richer every year, year after year after year without having any debt, and that's okay with us.

Question:

What is so attractive about veterinary diagnostics?

Arman Kline:

I think that question is in reference to our position in Idexx, which is a large one. It really comes down to three things. The first is it's a cash business unlike human health care, where there is a lot of reimbursement issues. Idexx is a cash business. Also, the average ticket is still relatively low; it's a couple hundred dollars a year that you would pay if you had a dog. That's probably not in New York City, but on average in the US. So we feel like that has some room to run.

The second thing is the market position of the company. Idexx is a dominant player in that market and we feel that it is in a good position to take advantage of that growth in the market. The third thing is the bond between humans and pets has been growing stronger, and that is really driving the spending. People talk about pets as being considered almost a child, and we think that is probably true. This company can take advantage of that trend.

Question:

What led to the purchase of Precision Castparts, and what are your thoughts on the company's diversification away from aerospace?

Greg Steinmetz:

For those who don't know, Precision Castparts — I guess the name implies it — operates in some very elemental businesses. It does castings and forging; it's been around for years. But it's not so easy to do this kind of stuff for aerospace. That creates a lot of barriers to entry, which allow a company like Precision to make a lot of money in this business. If it is not our best managed company, then its management is certainly our most vigorous. The CEO is constantly flying around the world. He is probably in a factory right now, asking employees about how they are taking out cost, how they are reducing inventory, how they are going to grow their sales.

It's a tough culture but it's a culture that works. As evidence of that, you think about what casting is — you have these huge forging presses, a very high-cost fixed-cost business. Last year its sales, because of the cyclical decline we saw in aerospace and some other things, fell 20 percent. For a fixed-cost business, normally that would be catastrophic. Precision's margins actually improved maybe 500 basis points and its EPS only fell about 10 percent.

We like that it is a great operator in businesses that show a lot of secular growth. Aerospace grows 6 percent a year. Energy infrastructure where they make things like pipes and they make blades for gas turbines, I don't think is as good fundamentally as the aerospace business. But in good times the profits are just as strong if not better for companies that have unique products.

I was with the CEO earlier this week and he told me about an opportunity I really didn't see coming. He bought a big piece of a company in China called Yangzhou Chengde Steel Tube. Chengde makes pipe, again a very fundamental business. It's easy to make them out of steel but it's hard to make them out of nickel. As you go down-hole in drilling a well, there is a lot of pressure, a lot of corrosion, and a lot of nasty things that can go on particularly when you go deeper. You need to use nickel to pull it off. There is only one company now that is making that nickel pipe, Sumitomo in Japan. Precision, through its investment in Chengde and its ability to leverage the nickel-making capacity it already has, is going to be able to make a down-hole pipe, which is the straw that sucks the oil up from the ground, with a larger diameter than what Sumitomo is making. Precision will be the only one making this.

By having these unique products, Precision is able to charge very high prices. It's probably good not to be 100 percent aerospace. You look at what's happened to aerospace over the years. There are times when it really can get beaten up. Diversifying is a way of employing fixed assets across a wider product range. So yes, we're comfortable with the move.

Question:

You commented last year on your overexposure to some of the retail sectors and as a consequence I think you made some liquidations. Can you comment a little bit on your position in Target?

David Poppe:

Retail has actually done well for us. We are overexposed but I like the positioning that we have, which is really heavily on extreme value retailing, whether that's Wal-Mart, Target, TJX. The auto parts guys aren't extreme value retailers but it's a necessity, it's not a discretionary purchase when you go there. As Rory mentioned earlier they have a lot of pricing power and the environment is good for them because when people are feeling economically stressed, do-it-yourself is a good option.

Our retailers tend to be focused more on needs and not wants. I don't think we have a heavy exposure to luxury or discretionary purchases at this point. As far as Target goes, it's a very well run store. It clearly had a difficult time at the start of the crisis. Its customers are a little more upper middle class than Wal-Mart customers. That customer was trading down to even cheaper formats or lower priced formats. Also Target relies a little bit more than some of the other retailers we're talking about on discretionary purchases.

As the months have gone by, Target has gotten the assortment right — more focus on consumables and need-based products, and it has done a good job there. It has done a very good rollout in food that to my mind looks better than anything it has ever done before in that area. Also Target took a big hit on its credit card when the crisis started. Management had been way, way too aggressive in 2006 and 2007 in issuing new credit, and Target got punished for that. But that cycle is playing itself out. It's still not perfect but it's getting better.

So honestly we own a lot of retailers, but they are all a little bit different. You could argue … Wal-Mart, Target — why you would want to own both of them? But I said this a few years ago and I still believe it — in the long term it's going to be a good thing to be exposed to the upper middle class consumer with a store that offers really good value. Wal-Mart will never touch that consumer I don't think, the same way that Target does. So I like owning them both. They have a slightly different customer, and they have a slightly different proposition and both are good.

Question:

This question may be a little bit beyond your traditional radar screen. But have you ever been tempted to buy a Chinese company and if not, what would it take to get you interested in that market?

Greg Alexander:

We read about things sometimes — frequently, actually. But there is an inscrutability factor. For example, there is a grocery retailer called WuMart. The fellow who founded it ended up in prison. Then one of our guys found this nice little company which was too small for the fund, but it was just fun to read about, called China Packaging. It was making some $20 million a year. Maybe it had $50-$60 million of cash. It didn't sell for much over the cash. Then one day we heard the cash that the company said that it had, it didn't have.

There is really no press — you see what happens with Google — and there is really no English language press — I don't think the Chinese language business press is that much bigger. So we prefer to look at the companies that do business in China. Danaher, actually, has a pretty thriving business there. Expeditors, which is a long-time holding and which has made the fund a lot of money, is a primary mover of goods from China and Hong Kong by air to the United States. So, so far, we've started indirectly.

David Poppe:

If you look at the example of Germany, where the accounting standards are different, the disclosure standards are different, management's attitude towards transparency is much different — we didn't do very well there. Not to blame it on accounting standards, but we didn't do very well there. To be in a developing world stock where the standards are all so different, we would be at an extreme disadvantage. We're not in those markets, we don't know those folks.

Greg Alexander:

China in particular.

David Poppe:

And China in particular. The standards are obviously not bad in every country but Germany is a pretty modern economy and we had a tough time there. You have to be humble about how much knowledge you are really going to have compared to the US or even Canada or the UK, where really standards are so similar that you can have a high degree of confidence. It's not just the language, it's the attitudes towards disclosure and transparency that really become a problem.

Question:

Can I get your comments on the trucking cycle?

Greg Steinmetz:

Truck production peaked in North America in 2006 at about 250,000 trucks. This year we are going to do about 115,000. We have been running below the replacement rate of about 200,000 for each of the last three years. This year is going to be another one and next year might not be so hot either.

Trucks wear out; so eventually you have to replace them. Right now our nation's truck fleet is about the oldest it has ever been; so when we get some volume back into the system, there is going to be a lot of replacement. With respect to our investment in Paccar, it might be a while, but we think that earnings will one day get to a point that will justify the current stock price, which is very high relative to earnings that six months ago at least were nonexistent.

It's a cyclical business. This cycle was worse than most past cycles. It's not always going to be that way, but it's always going to be cyclical. Right now we are getting to the point where we do see some signs of life, and things are picking up a little bit.

Question:

I'm curious about Ritchie Brothers — the capital allocation process and the holding in general.

David Poppe:

Ritchie Brothers has a unique model — it sells, as you know I'm sure, used industrial equipment at auction. The company is based near Vancouver, Canada. We think it's a unique model and really a better way to sell used machinery. That's been proven out over the last few years. It's grown at a very fast rate; it grows faster than the industry. But the number of buyers and the number of sellers who are attending these auctions every year has been growing at a really steady rate.

When you look at the enormous size of that market worldwide, Ritchie Brothers is very small compared to what it could be ultimately. So it's a business with a really long runway in front of it. The last year or year and a half has been really difficult. Things have in one respect slammed to a halt in that the volumes at auction haven't really been growing. But if you think about in North America, original new machinery from CAT, Komatsu or whoever, those sales are down on the order of 70 percent. There is no activity; there is no construction activity going on. People just aren't buying and selling equipment. The price of equipment has dropped. We can't measure it very well, but the company has probably taken an enormous amount of share just to stay flat in a market that is declining at the pace that the machinery market has declined at.

Why is Ritchie's a better model? Because if you take your used bulldozer to your local CAT dealer to sell it, the CAT dealers all have a very defined territory that they are allowed to sell in. If you do it in Pennsylvania, your dealer has the market of Pennsylvania that he can sell that bulldozer in. If you take it to a Ritchie Brothers auction, it literally has a worldwide market. If you go to one of these auctions, there are people from Latin America, from the Middle East, from Asia, people on the Internet there. You're getting the world price for that machine that day.

That's a better way to sell the machine, frankly, particularly for sellers who are in a little bit of distress or who are getting a new job and getting rid of the equipment they used on the old job. It's also very good cash flow-wise because it's guaranteed to sell at auction the day you bring it in. So it's a very fast turnaround. That's why we own Ritchie.

It has a high multiple; we bought it well and we'll do fine from the price we bought it at. But again, why is it a small position? One is that it's a smaller market cap; it's hard to get a lot. And two, trying to be disciplined on price with a high multiple stock.

The capital allocation at Ritchie Brothers has been aggressive but mostly pretty good. The company has kept the capex very high during this period. Management is a strong believer in its model and has not been willing to slow down the rollout of new auction sites. For 2011 the company is cutting back on that a little bit. A lot of their capital allocation though is to land. The auction site itself is really just 50 acres out in the middle of nowhere, where it can stack all this stuff. There are no expensive buildings or a lot of expensive computers that go into that.

Time will tell if the company is right. If we stay slow for four or five years, the returns on capital at Ritchie are going to come down. But it is still in the relatively early stages of building out the model worldwide. We're comfortable that in the long term that's going to be the right thing to do. But you're right; the returns on capital at Ritchie are going to be lower the next couple years because it continues to maintain the capex at $100 million a year when business is flat.

Arman Kline:

I would just add that people criticize Ritchie for buying the land. A lot of people ask me why the company doesn't lease it. That tends to be a popular question about capital allocation. We agree with management — those sites become very valuable and if you lease them, you are basically under the thumb of the landholder and the worst thing that could happen to Ritchie is that they lose a good site.

For example, Ritchie Brothers has a wonderful site in Orlando, Florida, right off I-4, huge sign, everyone sees it. It's become almost an annual event for the industry globally; people fly in from everywhere. If it ever lost that site, that would be a big disadvantage for the company. We don't mind the lower return on capital as a result of owning land.

Question:

I have a question on the industrial gas business in light of the consolidation that's taking place. And if you want to comment on Praxair specifically that would be enlightening.

Trevor Magyar:

I think this is a reference to Air Products' offer for Airgas. Airgas is a packaged gas player; these are the small scuba-sized tanks full of gas that is used for industrial purposes. Most of these tanks end up at small manufacturing sites around the country. Air Products has put in a very aggressive bid for the company.

I guess your question is about Praxair and its participation or lack of participation in that process. I would say that first of all Praxair does have a packaged gas business and it is a very successful and profitable one. One of the things that attracted us to Praxair is their discipline around returns on capital. So we tend to think about the businesses that we look at often in terms of return on capital but that's not a metric that every company in the world necessarily focuses on as much as we do.

Praxair is an exception. This is a company that is very much focused on return on capital. So when I think about its participation or lack of participation in this process I would guess that Praxair is not likely to pay a price that is going to risk ... it is not going to do anything to dilute its return on capital. So the company may well be involved in the process — we don't know; it's not public. But I trust that Praxair is going to be disciplined in the context of this process.

Question:

Because the fund is still very heavily into Berkshire, I'm not going to ask you to tell us all about the Berkshire portfolio. But can someone comment on the most material aspects of the Berkshire portfolio that we as indirect stockholders in Berkshire would find interesting at a meeting like this.

Jon Brandt:

There are about 6-7 businesses that might add up to 60 percent of the earnings. I'll start with Geico. Geico is a great business. It's got a durable competitive advantage in having the lower cost of acquisition, which leads to its being able to offer its customers lower prices. It has gone from a 2 percent market share to an 8 percent market share since '96. Geico will grow. And then Ajit's business, the reinsurance business, is a huge one. Gen Re is still big. People talk about how it hasn't grown that much but its float is still in the $23-$24 billion range and it's extremely profitable. Joe Brandon and Tad Montross really fixed that business and that's a billion-plus contributor to net profits every year. Iscar is not the largest manufacturer of cutting tools in the world, but it's, I believe, the most profitable. It certainly has the highest margins. Iscar should grow very fast.

Marmon is a whole bunch of different businesses, kind of like a mini-Berkshire. Berkshire currently owns 64 percent of it. It will own 100 percent of it by, I think, 2014. Its businesses will reflect the economy something like an ITW. MidAmerican is one of the larger utility companies. Berkshire makes a billion dollars from it. Maybe $1.2 billion this year. It's got pipelines, utilities in Iowa, four or five western states. It's one of the largest wind energy producers in the country.

Now the biggest unit of Berkshire would be the railroad, Burlington Northern. That business is recovering right now. But there are only two railroads that have networks that go from the West Coast to the Midwest. Burlington is one of those. Warren said when he bought it that it was an all-in bet on the economy and the increased transportation of goods in the US by rail.

It's not that all these businesses themselves drive the growth so much as, except for the Burlington, they are all very cash generative and Warren will hopefully put that money to work as he's done over 40 years. That's how it grows mostly; it's not a huge organic grower. Mostly it's about putting the cash to work at high returns or at least adequate returns.

In the equity portfolio, which I think of in the same way as I do the wholly owned businesses, the big holdings are American Express, Coke, Kraft, and Wells Fargo. Coke is a strong grower. American Express had a lot of difficulties in the recession because it was wholesale funded and it had significant losses in the credit card portfolio. But I think the company is back on its game and not lending money to people who can't pay it back, and they are going to focus on their upbrand market. I could talk all day about Berkshire, but I'll end there.

Question:

You had spoken about some of the negatives with respect to Omnicom and I was wondering if you could talk about what you like about the business and how you look at it.

David Poppe:

Sure. Omnicom is, I think by a pretty wide margin, the best of breed in that industry. There are four large consolidated holding companies. Omnicom owns three big agencies — BBDO, DDB, and TBWA — that are arguably three of the top five advertising agencies in the world in one holding company. They are all very strong creatively. Again, best of breed, to the extent awards matter, their agencies tend to win the most creative awards year in and year out.

Then as a financial business — management really proved the model in this downturn — it's a people business and Omnicom has a great ability to scale people up and down as required by the work. So when the work declined at the end of 2008, it was painful but the company was able to downsize people almost in real time as the work declined and Omnicom maintained the margin in 2009 within 60 or 70 basis points of what it had been the previous year, even though the revenue declined substantially.

There is no or very low capital intensity. In a people business, a creativity business, there is not a lot of capital that they need to put into the business year in and year out. There is a tremendous amount of free cash flow year in and year out, and management is a good capital allocator. So our frustration with Omnicom is sort of made worse when you look at it. The people are so good and the assets that they own are so strong that I become very frustrated that management would do something like this.

But I have to repeat, I think it's not appropriate behavior at the bottom of a really, really severe and once in a generation market decline to award 8 percent of the equity of the business to your senior management at prices that the stock hadn't seen in seven years. But that also doesn't take away from the fact that it is a very, very well run business.

Question:

Back to Berkshire and cash generation. I thought I read after the annual meeting — Buffett did not say so — but at least some journalists were inferring from Buffett's comments that he might be getting such an overwhelming amount of cash, looking forward, that he would be possibly paying a dividend. I wonder if you'd comment on it.

Jon Brandt:

A lot of people that I spoke to thought there was a difference in tone from his previous comments. I personally didn't find it to be so different from what he said in the past. He's been saying for years that Berkshire was getting bigger and if he couldn't put the money to work in a way that a dollar of retained earnings was going to be worth more than a dollar to the shareholder because of reinvestment opportunities, he would pay a dividend. My opinion is we're one year closer to that point. A lot of people agreed with what you said, with the press reports that he was intimating it. I haven't changed my gut feel of when that's going to happen. What's interesting is that he said in the past that he thought it made more sense for corporations to either retain 100 percent or pay out 100 percent. But this corporate obsession with a 30-40 percent payout ratio doesn't really make sense to him.

In certain cases, businesses have limited reinvestment or no reinvestment opportunities. It will be interesting to see when and if Berkshire does pay a dividend because another option is that he could just buy back stock. Even today with dividends taxed at a lower rate than say interest income or short term capital gains, it's still more tax advantaged to buy back stock. So when they do start quote/unquote "returning" money to shareholders it will be interesting to see A) whether it's share repurchase or dividends; and B) whether he goes go to a full payout as opposed to a partial payout.

Question:

I wonder if you could talk a little bit about Walgreen. The company has an increasing focus on growing through acquisitions instead of organic growth. What are your thoughts are on that, and why do you like the stock now, and what worries you?

David Poppe:

Walgreen has been through a really rough patch where there have been a lot of changes to management. And you're right — a lot of changes to the traditional model of focusing solely on organic growth of drugstores. It has bought a lot of healthcare services businesses, Take Care Clinic, which is a healthcare clinic it puts in the stores, home infusion businesses, specialty drug businesses. Mostly my sense is that it has not gone very well. I don't believe the company is making any money in those businesses; so that's been difficult to stomach.

On the drugstore side, we're sort of in the end game or getting close to the end game where there are two really strong players, and Wal-Mart out there on the retail side, and everybody else is being consolidated. So you had CVS buying Savon-Osco. You had CVS buying Long's Drugs. Now you've had Walgreen buying Duane Reade. There are a handful of regional chains and Rite Aid left, and my sense is that over some period of time the industry will continue to consolidate down to a few players. Typically that's good in an industry when the fewer players you have, the more market power the survivors have. So that should be overall a good thing for Walgreen.

More directly and maybe more tangibly right away, there is a double trend in drugstores that should be very favorable. You have a handful of blockbuster drugs that go generic in the next few years, Lipitor being the most well-known. New generic drugs are extremely profitable for drugstores because they are paid an incentive to convert people away from the brand to a generic in the first few months after the generic is launched.

Walgreen has also slowed down its capital spending program. Store openings are much fewer than they were previously and so the company is generating lots and lots of free cash. In the long run that means its growth rate will fall. But in the short run, it means actually a little bit better growth rate for earnings because new organically built drugstores lose money for three years. So that's also a good short term tailwind for profitability. And the company during this painful period where you probably know there was a very short-lived CEO who struggled in the job — it has done a lot of restructuring and taken a lot of inventory out of the stores. That should also generate free cash flow that can be put to good use for the shareholders. So there are reasons to like the stock.

If I'm being totally candid about my own feelings, there are questions about whether this management team is doing a great job. The acquisitions mostly haven't worked. The Duane Reade acquisition to us looked irrationally expensive; Walgreen paid more than it should have. I think some of the changes that the company has made to the stores, while they make a lot of sense, haven't generated a lot of benefit for the shareholder. So it's a little bit of a frustrating time to own Walgreen because there are more mistakes than there is solid execution going on. Going forward, you can see that if it can get its act together, there are reasons to be pretty optimistic, the future consolidation and this tailwind of more generic drugs being the two most obvious ones.

Question:

Thank you, I just wanted to follow up on that, David. I wonder if you could comment on Walgreen's competitive position vis-a-vis CVS, because it seems as if CVS — again, I'm not an expert on this so that's why I'm asking — but it seems as if CVS hasn't done a much better job with their Caremark acquisition.

David Poppe:

We don't own CVS and haven't for some time. My impression is the same as yours — it's funny, CVS stock has not really performed very well recently, either. There is a lot of skepticism and negativity towards the Caremark deal. My own efforts to understand that — when you talk to PBM clients who do business with Caremark, they mostly like Caremark. I don't get a sense that people are very unhappy with the way Caremark administers benefits. There is a lot of concern about conflict of interest, of Caremark trying to drive people into the CVS drugstore, and Caremark's maybe being run a little bit for the benefit of CVS. I'm oversimplifying a little but I think there is some skepticism there. Caremark has lost some clients or it has not won bids at the rate it expected, I think, because Medco and Express Scripts do a very good job of selling against them on this idea that CVS is conflicted — it's trying to drive business into the drugstore.

On the drugstore side, CVS has done a really, really good job integrating its acquisitions, and it has paid smarter prices than what Walgreen paid for Duane Reade. But Duane Reade was small and Duane Reade — I could see how strategically New York City is an important market for a company that also has a huge presence in Florida, to be able to have both those markets — there are some benefits there. But in general I would agree with you. CVS has taken a little bit of a beating on the PBM side and done a very good job on the drugstore side with their acquisitions.

Question:

Can you talk a little bit about MasterCard — specifically has the moat changed at all through the regulations or proposed regulation changes?

John Harris:

The moat changed today because a surprising legislative development happened. Right now the Congress is debating financial reform, as everybody knows, and the way it works in Congress is when you've got a moving train, everybody tries to jump on. So even though this bill is not nominally directed at the credit card industry and even though the Congress already passed a slew of new regulations for the credit card industry not long ago, opponents of the credit card industry in Congress are trying to push their agenda onto this bill. While the consensus view was that they would not be very successful in doing that, the consensus view it appears was wrong because today or I guess yesterday an amendment was passed and attached to the bill. The amendment will give the Federal Reserve Board the right to regulate the interchange rate on debit card transactions.

Just very, very quickly — because this industry does get a little complicated — when you buy something that costs $100 with a credit card, about $97.50 of what you pay on your credit card goes to the merchant and another $2.50 goes into what you might broadly call the credit card system. About 50 cents of that roughly is paid to the merchant's bank and the other $2 roughly is paid to the bank that issued you your credit card. The $2 that goes to the issuing bank is what is traditionally called interchange. There are many people in the world who believe that interchange rates on credit card transactions and debit card transactions are unjustifiably high. There is a whole range of arguments as to whether they are or they aren't.

But suffice it to say it's likely as a result of this amendment that the interchange rate on debit card transactions is going to go down. What exactly that means for the card associations — meaning Visa and MasterCard — is open to some debate. Because they do not directly receive any interchange. The merchant's bank receives some, the credit card issuing bank receives some, and then they turn around and pay a relatively small fee to Visa and MasterCard for operating the network on which that transaction takes place.

If there is $2.50 of vigorish there in the system, maybe only between 15 and probably 20 cents of that might end up in the hands of a Visa or a MasterCard. So it's a relatively low percentage of the total pie there. The competitive position of the networks relative to their bank customers is very strong because there are only two of them and there are not a lot of alternatives. If you want to execute a credit card transaction, you've got to do it over somebody's data network, and those are the only two global data networks in existence. Recreating them is not a very easy thing to do because they reach millions and millions of merchants, not just in the United States but all over. There is a reason why you can use your credit card in every corner of the globe, and recreating a network of that size and robust strength is not easy.

So it is very possible that even though issuing credit cards and debit cards and processing debit card transactions may become less profitable for the banking industry, banks may not have the ability to get fee cuts from Visa and MasterCard. So it's not really clear what all this means for Visa and MasterCard, except it's pretty clear what it means for their stocks, which is that it's not good, because they are both down about 10 percent today.

What it will mean for the businesses is another matter. It would be hard to characterize this as anything that is good. But the reality is it was coming; so it's just coming a little sooner than people thought. I think the house view of Ruane, Cunniff & Goldfarb is that regulation was coming; it was a matter of when and not if. We felt that it was certainly going to come when the very large class action lawsuit that the banking industry is litigating with the merchants of this country comes to a head. We felt that was going to result in a change in the system that was going to be something along the lines of what you saw today. But at least part of that change is going to come sooner. It's probably not great, but it's ultimately not clear what it means for the associations.

In the meantime, the stocks obviously reflect some of the damage that's been done by the Congress. If you separate this regulatory issue, the reason that we have held our MasterCard position for so long in spite of having made so much money on it is that these are just intrinsically extraordinarily attractive businesses. They are worth, in the absence of regulatory risk, an awful lot of money. The question is are you adequately paid for the regulatory risks that you're taking as an owner. We struggle with that question. Sometimes the answer to it is more obvious than at other times. But by virtue of the fact that we still own the stock, we're making a statement about how we feel about that.

Question:

In the comments that were just made on MasterCard and Visa, I'm curious why you spoke as though American Express is not a player.

John Harris:

American Express operates a different kind of system. It's what's called a closed loop. So American Express is — when I buy something with my Visa card, as I said, there is one bank that's the merchant's bank, that's the acquiring bank. There is another bank that's the issuing bank of the card, that's a separate bank. Then in the middle you have a third party which is Visa or MasterCard, the network. When you buy something with American Express, all of those three parties are one party. American Express does all of it.

American Express is the acquirer, American Express is the network, and American Express is the issuer. So American Express is considered something different than Visa or MasterCard because of the way the business is set up. First of all, American Express — you don't have some of the power relations in between those three parties with American Express that you do with Visa or MasterCard, because it's all one party. So some of the objections that some people have to the way the three party system works and whether the three party system amounts to basically a facility for price fixing by banks and the associations, you can't really make that claim with American Express because it is just the system and it is setting its own prices.

The other thing American Express has going for it is that it is a smaller portion of the credit card business in the United States than Visa and MasterCard are. As a merchant, you have a choice whether you want to accept American Express or not. There are some merchants that would tell you they don't really have a choice because all their clients whip out American Express cards, especially merchants that cater to wealthy individuals. They would say they don't really have a choice because their customers wouldn't be very happy if they didn't allow them to use American Express. But I'm sure all of you have been to merchants where in point of fact you are not able to use your American Express, and that's because American Express charges a higher fee on the transaction than Visa or MasterCard do, and some merchants just decide they don't want to pay that fee and their customers will be okay with that.

Question:

The Fund owns a lot of Treasury securities, and they get rolled over, over time, even though they are short term. What would be your guess or estimate about where the 10-year bond yield might be at the end of this year and the end of next year?

Greg Alexander:

We wouldn't have an opinion on that. We see the deficits; we see Europe has — Greece, Italy, Portugal, Spain, and the UK — have deficits almost or sometimes worse than we do. So what do they do? They solve the problem with the bailout. Where does the bailout money come from? It's just more deficits. I'm totally baffled why people are excited about the bailout. So we have a bias that we want to keep our Treasuries short because maybe rates will go up someday. But we don't know.

Bob Goldfarb:

I'd say we're risk averse, and that's our safe money, we don't want to risk it.

Greg Alexander:

As a general statement for all of you, sometimes people take money out of the stock market and then they want to have fixed income. Then they start looking around for what things have a high yield. We don't really agree. Safe money should be safe, as Bob said.

Question:

Do you have an ideal construction of your portfolio as far as 20 positions of 5 percent each — leaving out the legacy Berkshire type position? What do you aim for?

Bob Goldfarb:

Your idea of 20 positions makes sense but I wouldn't necessarily have all of them at equal weight. We're never going to have positions at a minimum of 5 percent unless we exclude a lot of fine smaller companies. And we don't want to do that. For example, we bought a lot of Idexx but its market capitalization was small when we bought it and it was consequently less than 5 percent. But because of the growth, it's now significantly more. We don't want to preclude ourselves from those kinds of opportunities.

Question:

Mr. Goldfarb, you spoke before about the fiscal problems of California. Then you said New York is next year. Could you expand on that?

Bob Goldfarb:

I think I said New York and then I mentioned New Jersey, which to me is a particularly interesting example because you have a new governor who is determined to take harsh actions to address the deficit. He's encountered resistance, strong resistance from the teachers unions and public sector employees. So I'd keep my eye on New Jersey because we'll see if people favor reducing deficits by paying their fair share or whether they want to reduce deficits courtesy of the other guy. Greg?

Greg Alexander:

I'm not saying anything everyone doesn't know already. But it's just astounding — we know that the politicians are different from us, but I feel disaffected. They are not writing the check; they don't seem to care what they are doing. Bob for years has been upset about pension assumptions and I have a friend who works for the gubernator in California who has been writing all kinds of articles about it, and has gotten some attention. Like the city of Vallejo in California, 40 percent of their budget is on pensioners. What are they thinking?

So the fellow who found a bomb in Times Square — I don't know if you noticed — but he was quote "great job, thank you very much." He's months away from retirement; how old was he? Do you remember from the press? He's months away from retirement; he's 43. Then he'll retire on a full pension. In his case, I'd say okay. If you find a bomb, okay. But what are you thinking? I mean, 20-something million unemployed are giving up looking for work. When they work, they are paying for this guy's pension, for everyone else's pension.

Question:

You talk about potential not imminent inflation and try to find companies with pricing power and that are financially strong. I guess that's been debated over the years. We haven't seen inflation in so long. Can you comment on that? Is there really an answer to inflation? Maybe Jon can talk about Buffett's 1977 article in *Fortune* where he wrote that inflation was the cruelest tax, and that contrary to popular belief, you can't win with companies and inflation.

Bob Goldfarb:

I think a clear inference of that piece is that companies that generate a lot of cash and have minimal required reinvestment of that cash in their business and that can grow with minimal cash are terrific inflation hedges. I think that was true in 1977 and I think that's true today.

Jon Brandt:

The title of the article was a little misleading. It was "How Inflation Swindles the Equity Investor," and it talked about how capital intensive businesses have to keep putting more money into their inventory and receivables and other sources of capital when dollars inflate. But as Bob points out, he also said elsewhere that if you buy a company that doesn't have great capital needs, you can avoid most of that inflationary tax.

Bob Goldfarb:

And then he went out and bought a railroad!

Question:

I'm curious if you have any thoughts on electric or gas utilities. We're in a period where the dividend yields on the common in some cases exceed what the coupon rate is on the debt — if there is any opportunity there?

Bob Goldfarb:

Rick?

Rick Cunniff:

Too big a subject.

Bob Goldfarb:

We're really not that well versed in that area and it has not been an area that we've emphasized. If anything, we've deemphasized it.

Jon Brandt:

Just because the common is more attractive than the debt doesn't mean that the common is on an absolute basis attractive compared to common stocks of other companies.

Question:

Can you comment about WR Berkley?

John Harris:

WR Berkley for those of you who don't know — I was going to say it was one of the best managed insurance companies in the country. I think that's a fair thing to say. Certainly Bill Berkley who runs the company and who has run the company since its founding has one of the best records as an insurance company manager and investor of anyone who has ever managed or invested for an insurance company in the United States, and he is to be enormously respected. Insurance in general is out of favor in the stock market these days — we were aware of it, we spent some time analyzing the industry in the hopes of taking advantage of that. In the end we did buy some Berkley.

It's a well run business in an industry where you need competent management because the income statement is made up every year and you can write down whatever you want your expenses to be and that's what they are. You're not going to find out for a long time whether what you wrote down was right or wrong. So it's imperative to be with conservative, trustworthy and capable people. Or else you're going to have a lot of problems.

He is certainly all of those things. So that coupled with an attractive price led us to buy some stock. The one reason why it's not a bigger position is that we think the compensation there is objectionable. He pays himself a lot of money in spite of owning a very, very large chunk of stock in the company. It's hard to justify. It's his business, he calls the shots, he's the controlling shareholder and we don't have to own the stock — and I think that's exactly what he would tell you if he were standing here and I think it's all true. So it's a decision that we have to make about whether we're comfortable with the way he runs the business in that area or not.

I guess the decision we made was we're sort of comfortable with it but not totally and we're still thinking about it. So that's why it's a small position and it's possible it might get a little bigger over time; it's also possible it might go away because we may just decide as we have in other situations similar to this where there are disagreeable compensation practices that the more we think about it the less comfortable we are. It's in that sense on the margin.

Question:

Why did you reduce Brown & Brown?

Bob Goldfarb:

It is going through an awfully difficult period. The company has gone through it and there is no prospect of imminent change. One reason is that it is commission-based; so as rates in property and casualty insurance go down, commissions decline. Second is we never thought of the property and casualty insurance business as being particularly economically sensitive. It's sensitive to its own cycles, but in this case in the great recession, the number of exposure units has just declined so much, and the value of the exposure units that remain has also declined.

And the crown jewel is Florida retail. It's based in Florida and the regulatory structure for wind storms with the state entering the insurance business ... it just has enough headwinds. I think over time those will change and the company will do fine.

Before we adjourn, I think Rick Cunniff would like to make a statement.

Rick Cunniff:

I just would like to say that in less than two months, the Sequoia Fund will celebrate its 40th anniversary. The fund was initiated on July 13, 1970. A little sidelight to that is that the name of the fund originally was filed as the Cimarron Fund. I think Bill Ruane liked the mellifluous sound of that name and the attorney, Seward & Kissel, checked. Our lawyers passed on that. They said it was okay, no conflict with another corporate name.

But shortly thereafter, we got a letter from a limited public partnership in Massachusetts named the Cimarron Fund. At that time there were quite a few partnerships in Massachusetts that had gone public. So we had to come up with a new name. I can recall spending the good part of a Sunday going through the dictionary and I came up with Sequoia Fund which we accepted.

Bob Goldfarb:

Thank you all for your questions and for your attendance. We look forward to seeing you a year from now.