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BERKSHIRE HATHAWAY'S 2012 ANNUAL MEETING

Regular readers of our semi-annual *Investment Commentaries* are quite familiar with Warren Buffett, Chairman of Berkshire Hathaway. Each year we make the pilgrimage to Omaha, Nebraska to attend the annual shareholders meeting and to absorb his wisdom and that of his partner, Charlie Munger.

Buffett is arguably the world's most successful money maker having accumulated more wealth than the Gross Domestic Product of more than half the world's countries. What is remarkable is that he has done so by simply applying sound investment principles and buying into great companies at the right prices.

His investment record with Berkshire Hathaway is significantly better than any market index over the last 47 years, and one cannot simply attribute it to good fortune or chance. Clearly, Warren Buffett is the greatest investor of our time, and there is much to be learned from his writings and answers at the Berkshire Annual General Meeting.

This year's meeting was held on Saturday May 5th and, as usual, it did not disappoint. In addition to taking questions from audience members and a panel of journalists, this year saw Buffett and Munger welcome questions from a three-member panel of analysts as well. Here are just a handful of answers to questions we deem to have been the most relevant. Enjoy!

WHAT TO AVOID WHEN INVESTING

- Buffett advised to always stay away from things that you do not understand. He said you need to have a notion about what the earning power and competitive position of a business will look like in the next ten years. "That eliminates a whole bunch of things."
- He added that if the price is crazy even though he understood a business he would eliminate another bunch. "So you get down to a very small universe."
- Buffett said he could not recall any time in last 30 years that he bought a new issue. "The idea that a seller who has the choice of when he can come to market and that the security is going to be the single cheapest thing to buy out of thousands and thousands of businesses in the world is nonsense. You know it can't be attractive, but people get excited about it anyway."
- Buffett said you don't have to do very many things to have success in investing. You just have to do one or two things where you don't make a big mistake and every now and then one works out very well.
- Munger added that if there is a very high commission involved, you would be best to look elsewhere.

MISTAKE MINIMIZATION

- Buffett admitted that he makes mistakes and will make more over time. Said he does not sit around worrying about them and that Berkshire thinks in terms of not exposing themselves to mistakes that affect their ability to play tomorrow.
- Munger added that the best thing to do is to learn from other peoples mistakes because it was a much more pleasant way to learn hard lessons.
- Buffett added that when you look at the folly of humans, the financial area will give you plenty of material to look at. He thinks understanding those follies and how human beings behave will give you an advantage over time.

WARREN'S HEALTH

- Buffett said he feels terrific and spoke to four doctors – at least two of which owned Berkshire Hathaway – two weeks ago for several hours. They described various treatments, none of which involved a day of hospitalization, required him to take a day off of work and pointed out that the survival numbers were way up – 99.5% for 10 years.
- He said was a very minor event and joked that had a better chance of being shot by a jealous husband.
- Charlie joked that he resented all the attention and sympathy Warren was getting because he probably had more prostate cancer than Warren did, but admitted that he doesn't know because he doesn't let them test for it.

BERKSHIRE UNDERVALUED – WHY?

- Buffett said in 47 years at Berkshire, there have been several times when he thought the stock was significantly undervalued and added that if you run any business for a long period of time, there will be times when it is overvalued and times when it is undervalued.
- He said the beauty of stocks is that they do sell at silly prices from time to time and that was how he and Charlie got rich. He pointed to Ben Graham's *Intelligent Investor* and said chapters eight and twenty were all you really needed to know to get rich in this world.

- He expanded by saying that chapter eight introduces the character of Mr. Market and refers to him as a psychotic drunk that will do very weird things over time. “Your job is to remember that he is there to serve you and not advise you. If you can keep that mental state and realize that Mr. Market is making lots of mistakes on the thousands of prices he is offering you on daily basis you will do well.”
- Buffett said stocks get mispriced and Berkshire was no exception. “The important thing is to make your decision based on what you think the business is worth and stick with businesses you have good reason you think you can value. If you do that, you simply have to do well in stocks.”
- He concluded by saying the stock market is the most obliging money making place in the world. “It is a marvelous game and the rules are stacked in your favor as long as you don't turn those rules upside down and start acting like the drunken psychotic instead of the guy that is there to take advantage of him.”

BERKSHIRE SHARE BUYBACK

- Buffett wants share price to be significantly undervalued to do a buyback and wants to be very sure that shareholders themselves know that the price is undervalued.
- From strictly a money making viewpoint, they would love to buy billions and billions of dollars worth of stock at 110% of book value [\$109,846] and if he got the chance to do it, and the move did not take Berkshire's cash position below 20 billion, they would buy very aggressively at that price.
- He added that doing so would make significant money for remaining shareholders.
- Charlie chimed in saying that some companies buy their own stock back regardless of price and that was not the system at Berkshire. He thinks most plans are idiotic and are setup mainly to indulge the egos of CEO's. The only reason they would buy back shares was to increase the value of Berkshire stock the day after they do it.

BUSINESS SCHOOL TRAINING

- Buffett said schools teach students lots of nonsense about investments.
- He said that the silliest stuff coming out of major business schools has been in the investment area because schools focused on one fad after another in finance theory and that those theories are usually very mathematically based.
- He added that when it becomes popular it is very difficult to resist these theorems because going against the revered wisdom of your elders could be very dangerous for your career path.
- Buffett said if he were teaching, he would only have a couple of courses. One on how to value businesses and one on how to think about markets.
- He thinks that if people grasped the basic principles in those two courses, they would be far better off than if exposed to things like modern portfolio theory and options pricing.
- When Ray Kroc started McDonald's he wasn't worried about the options prices of McDonald's stock. He was worried about how to sell more hamburgers.
- Said business schools have totally drifted away from how to value businesses and that was what investing was all about. He said "if you buy a business for less than it is worth, you are going to make money. If you know the difference between the businesses that you can value and those that you can't, you are going to make money. Schools are trying to make things more difficult than they really need to be."

BERKSHIRE VS GOLD

- Buffett said when they took over Berkshire, gold was at \$20 and Berkshire was at \$15. Gold is now at \$1,600 and Berkshire is at \$120,000.
- He said it is very hard for an unproductive asset like gold, to beat productive assets over any long period of time and added that he had no interest in ever wanting to own gold and would bet his life that over the next fifty years, equities will do better than gold.

- Buffett admitted that gold aroused people's passions and said he could criticize bonds and Bernanke would still smile at him, but if he talks negatively about gold people take it as a personal attack. He cautions against such behaviour and thinks decision making should always be based on fact and not emotion.

SYSTEMIC FEARS

- Warren said in the 52 years he and Charlie have worked together, they have never had a discussion about buying or selling a stock or business where they have talked about macro affairs.
- Said if they find a business they like and understand and that the price was right, they buy it. "It doesn't make any difference what the headlines are, what the Federal Reserve is doing or what is going on in Europe, we buy it. There will always be good and bad news out there – which gets printed depends on the mood of newspaper editors. We look to value not to headlines."

EUROPEAN BANKS VS. U.S. BANKS

- Warren said he had a decidedly different view on both. Said American banking system is in fine shape and in a far better position than they were 3-4 years ago.
- He pointed out that American banks have written off most of the abnormal losses that existed in their portfolio's three years ago, that they buttressed their capital in a very big way and now have liquidity coming out of their ears.
- He pointed out that unlike American banks, European banks did very little to raise capital and are now losing their funding base. He added that European banks on average had more wholesale funding than American banks and that in such a system, money can run out pretty fast.
- He said European banking system was gasping for air a few months back, which is why the ECB opened up its wallet and came up with roughly a trillion Euros of liquidity for those banks to replace their funding.

- Munger said that it is very difficult to handle economic stresses in Europe because they don't have a federal union.
- Warren added that when you get 17 countries that have surrendered their sovereignty as far as their currencies are concerned you get a big problem. He joked that Henry Kissinger put it best when he said "if I want to call Europe, what number do I dial?"

COAL, OIL & NATURAL GAS

- Buffett pointed out that there now was a 50:1 ratio between the price of oil and natural gas and, had you told him five years ago that such a ratio would exist, he would have asked what we were drinking.
- He said it will be interesting to see how this ratio will play out because current pricing has changed people's thinking in such a short period of time.
- Warren talked about electricity generation and said that in the future although we will see a diminution in the percentage of electricity generated from coal it will not be a dramatic one because the installed base and the megawatts involved are huge to have wholesale change.
- Munger believes that using up a precious resource like natural gas over thermal coal, which is precious but not as precious, is idiotic. He said if he were running things, he would use up every ounce of thermal coal before he touches a drop of natural gas. He thinks the natural gas reserves recently found are one of the best things we could leave our descendants and is in no hurry to use them.
- He added that it would be crazy to do so with natural gas at these price levels.

BERKSHIRE POST BUFFETT

- Buffett said that unlike most companies, Berkshire stood for something different and because the Buffett family will retain control of votes for a very long time after his death, that would not change.

PUBLIC OWNERSHIP & VOTING SHARES

- Buffett said he virtually never voted against management because when he buys a business, he generally likes the management and direction of the business.
- He said they were not in the business of trying to change people. "It's like marrying someone to try and change them - it just doesn't work very well. We accept people the way they come and simply concentrate on who we choose to associate ourselves with."

HEAVY RESPONSIBILITY THAT FALLS ON SUCCESSOR

- Buffett said it was up to him to avoid anything big that could hit Berkshire. He believes that a CEO can't delegate the chief risk officer role and that at Berkshire, the function was as important as capital allocation. On that note, he said his successor is an excellent risk manager.
- Munger added that risk management is often wrongly delegated to people with strong math biases who rely on models taught in business schools. He thinks "these risk models are the dumbest thing ever put forward!"
- On deal-making, Buffett said that he had no connection in life with Bryan Moynihan at Bank of America prior to approaching him to do a deal. He said "what's important is that Berkshire can act with speed and finality, and the ingredients to continue to do deals will still be there because people believe Berkshire can get them done."

WAL-MART HEADLINES

- Buffett said it looks like Wal-Mart may have made a mistake in the way the situation in Mexico has been handled, but that it did not change the fundamental dynamic of the business.
- He admitted it is a huge diversion of management time and is costly, but does not think the earnings of Wal-Mart five years from now will be materially affected by the outcome of this situation.

ENTRENCHED LEADERS IN TECHNOLOGY

- Buffett said Google and Apple look very tough to dislodge where they have their strengths and he would not be surprised to see them worth a lot more ten years from now, but would not want to buy either one because he does not have the level of conviction required to do so.

STATISTICAL PROBABILITY & RISK

- Buffett said he thinks about worst case scenarios all the time and that is why they use margins of safety and build in layers of safety that others might regard as foolish.
- He said he will never risk what they have and need for what they don't have and don't need. He added that they will always find things to do where they can make money, so they will never stretch to do it.
- Munger asked how all these super smart people with degrees in mathematics always end up doing dumb things. He thinks it's explainable by the old proverb that to a man with a hammer every problem looks like a nail. "They just twist the problem to fit the solution."

SOVEREIGN DEBT LEVELS

- Buffett said the world has seen many failures of sovereign debt over history and that the end result of them is a big geographic reallocation of wealth. He noted that the wealth does not disappear.
- He does not know how things will play out in Europe and added that he would much prefer a world that was getting its fiscal affairs in order but sometimes when you are making your way out of a recession, that is sometimes difficult to do.

- He said at present rates, would avoid buying medium and long term government bonds.
- Munger chimed in by saying that the U.S. used up some of its store of fiscal virtue. The one thing he is sure of is that it is safer in deficit financing times to use the money intelligently to build things that society needs rather than throw it away. He would use the money on infrastructure and would have the whole country pay more tax.

BUFFETT TAX AND ITS EFFECT ON SHARE PRICE

- Buffett said he doesn't think any employee of Berkshire, or CEO's of companies they own shares in, should have their citizenship restricted.
- He added that if you start selecting your investments or your friends or your neighbors based on trying to find people that agree with you totally, you will have a pretty peculiar life.

AQUISITION FUNDING OPTIONS

- Buffett said they recently considered a large acquisition for about \$22 billion but they could not agree on terms and the deal fell through.
- He pointed out that although they used 30% stock in the BNSF acquisition, it is highly unlikely that they would use stock again.
- Buffett added that if a deal pushed cash below \$20 billion, they would sell existing securities and do whatever was necessary to have a \$20 billion cash balance after the deal was done.
- He joked that if you had a \$20 billion dollar deal, he had a 1-800 number.

JOBS COMING BACK TO U.S.

- Warren said of the 270,858 employees they employed at year end, they didn't have more than 15,000 outside of the U.S.
- Said if you were to look at Berkshire ten years from now, it is extremely likely that they will have many more employees and some of those will be outside of the U.S.

WHAT AREAS WOULD YOU LOOK TO TODAY IF STARTING OVER

- Warren said there were opportunities today and would probably do very same as he has already done. The difference being he would do so a little earlier and buy businesses of significance and interest and look to buy them for keeps.

WICH BUSINEESES IMPROVED THEIR COMPETITIVE ADVANTAGES

- Buffett said "no question it's the railroad business. For very fundamental reasons, it has improved its position dramatically over the last 15-20 years and continues to do so to this day." He added that it was an extremely efficient and environmentally friendly way of moving things and that the asset could not be duplicated for four, five or even six times what it was selling for.

CEILING AND FLOOR ON BERKSHIRE STOCK PRICE

- Buffett noted that there could be circumstances in which they would buy lots of stock and that any kind of a chaotic market would provide the opportunity.
- He said if he thought he could buy a whole lot more at a slightly higher price, he would probably adjust the price.

EXPERIENCE WITH NEW MONEY MANAGERS

- Buffett said they have always been much more concerned about how a record was achieved instead of the record itself. With both Todd and Jeff, he and Charlie were stuck by not only their records, but by their intellectual integrity, qualities of character, and a real commitment to Berkshire.

EXECUTIVE COMPENSATION

- Buffett said they give their executives the paint brush so they can continue to paint their own picture and simply applaud and compensate their work fairly.
- He said that he can't put the passion into someone about their jobs, but he can certainly create a structure that takes that passion away from them. "Berkshire focuses on not messing up something that is already good."

HOW TO BUILD A BARRIER TO ENTRY

- Munger said they buy barriers rather than build them.
- He added that a long time ago he discovered that frequently all it took was one competitor to ruin a business.
- Buffett said that in certain industries you will never have barriers and that in those cases, you'd better move fast.

WIND, SOLAR & NATURAL GAS

- Buffett said they entered solar only six months ago but have been doing wind for quite a while.
- He added that Berkshire has a competitive advantage in this area because they can take advantage of tax credits in the energy field whereas 80% of companies in the U.S. are unable to reap the full tax benefits because, unlike Berkshire, they do not pay any federal income taxes.
- He said that neither solar nor wind projects would be working without subsidies. “In the case of wind, the subsidy is \$0.022 per kW/hr and it’s the subsidy that makes wind projects work.”
- He added that wind was a supplementary type of generation, and could never be part of your base generation.



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